United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

76-7259

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United States Court of Appeals
FOR THE SECOND CIRCUIT

THOMAS J. BYRNES and FRANCIS R. SANTANGELO,
Plaintiffs-Appellants,

—against—

FAULKNER, DAWKINS & SULLIVAN and
SINGER & MACKIE, INC.,
Defendants-Appellees.

FAULKNER, DAWKINS & SULLIVAN,
Counterclaim-Plaintiff,
Appellee Appellant,

—against—

THOMAS J. BYRNES and FRANCIS R. SANTANGELO,
Counterclaim-Defendants,
Appellants, Appellees,

and

TOBEY & KIRK,
Counterclaim-Defendant-Appellee.

ON APPEAL AND CROSS-APPEAL FROM THE UNITED STATES
DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR DEFENDANT-APPELLEE AND CROSS-APPELLANT FAULKNER, DAWKINS & SULLIVAN

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United States Court of Appeals

For the Second Circuit

Thomas J. Byrnes and Francis R. Santangelo,
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—against—

Faulkner, Dawkins & Sullivan and
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Faulkner, Dawkins & Sullivan,
Counterclaim-Plaintiff,
Appellee, Appellant,

—against—

Thomas J. Byrnes and Francis R. Santangelo,
Counterclaim-Defendants,
Appellants, Appellees,

and

Tobey & Kirk,
Counterclaim-Defendant-Appellee.

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on appeal and cross-appeal from the united states district court for the southern district of new york

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BRIEF FOR DEFENDANT-APPELLEE AND CROSS-APPELLANT FAULKNER, DAWKINS & SULLIVAN*

STATEMENT OF THE CASE

A. Nature of the Case

This appeal and cross-appeal arise from the dismissal of all claims between all parties to this action upon motion and a cross-motion for summary judgment. The claims arose from two sales contracts entered into by plaintiffs through their securities broker, counterclaim-defendant Tobey & Kirk: the first, a June 7, 1971 agreement to sell

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*Permission was granted to file a brief not exceeding 130 pages.

44,000 shares of the common stock of White Shield Corporation at $14.00 per share to defendant Faulkner, Dawkins & Sullivan ("Faulkner"), and the second, a similar contract of sale of 1,500 shares made on June 8, 1971 to defendant Singer & Mackie, Inc. ("Singer").*

Neither sale was ever consummated. On the settlement date—June 15, 1971—Faulkner rejected the stock and cancelled its purchase upon discovering that plaintiffs and Tobey & Kirk had misrepresented material facts in connection with the sale, had engaged in numerous violations of the federal securities laws and state law in connection therewith, had engaged in a manipulative distribution of White Shield stock of which the sales to Faulkner and Singer were part, and had delivered stock which Faulkner could not accept. Singer cancelled its purchase for similar reasons on June 16, 1971, the settlement date of its contract.

In forcing the cancellation of the sale, plaintiffs damaged Faulkner in the amount of $1,875. That sum equals the aggregate mark-up which Faulkner would have realized upon two contracts for the resale of 20,000 of the White Shield shares, which Faulkner had entered into on June 7, 1971 with Singer and with Mitchum, Jones & Templeton, Inc. ("Mitchum") immediately after purchasing the shares from plaintiffs. Upon rejecting plaintiffs' stock, Faulkner was forced, in turn, to cancel its resales thereof. Thereafter, plaintiffs allegedly sold the stock rejected by Faulkner to others on the open market between August 9, 1971 and September 28, 1971 at a loss.

From the foregoing events the following claims asserted in this action arose:

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*In February, 1975, all parties to this action except Singer, which had been dismissed from it in 1973 for lack of subject matter jurisdiction, entered into a Stipulation of Facts (the "Stipulation") with a view to the disposition of this action by the then forthcoming motions for summary judgment. The facts as to plaintiffs' ownership of the White Shield shares, Faulkner's contract to purchase and Tobey & Kirk's role as broker appear in Nos. 3-4 of the Stipulation (A-100-1).

(a) plaintiffs' claim against Faulkner for an alleged breach of its purchase contract for the White Shield stock (plaintiffs' "contract claim");

(b) Faulkner's securities law and state law fraud and contract claims against plaintiffs and Tobey & Kirk seeking compensatory damages, including Faulkner's lost mark-up on its cancelled resales, punitive damages and the expenses of this action and a prior action, including reasonable attorneys' fees; and

(c) plaintiffs' claim against Singer for an alleged breach of its purchase contract with them.

The plaintiffs contend that they acquired their stock of White Shield Corporation on or about September 6, 1968 from certain officers and/or directors of White Shield Corporation. The stock was not registered under the Securities Act of 1933. Plaintiffs made investment representations in connection with their acquisition and transfer of the stock was restricted. Some of the stock was recorded in the name of Byrnesan Associates, a partnership formed by plaintiffs. At the time of their acquisition of the stock, the plaintiffs also acquired the right to include the stock in a registration statement filed under the Securities Act of 1933 at some future time (A-164).

In 1971, White Shield Corporation filed several registration statements under the Securities Act of 1933. Plaintiffs' stock was included in one of those registration statements. That registration statement also included stock of two of plaintiffs' associates by the names of Peer T. Pedersen and Vincent Draddy. Some of the stock of Pedersen and Draddy was also recorded in the name of Byrnesan Associates (Stipulation, No. 1; A-100, 139 n.2).

An aggregate of 148,000 shares were registered for sale on behalf of plaintiffs and their associates. The registration statement which included those shares was a

so-called "shelf registration" or "shelf secondary", i.e., a registration statement filed on behalf of and naming the owners of the stock as selling shareholders, for the sale of the stock in the open market from time to time, generally through member firms of the National Association of Securities Dealers Inc. ("N. A. S. D.") (Stipulation, Nos. 1-2; A-100). The common stock of White Shield Corporation was traded in the over-the-counter market and was regularly quoted in the "Pink Sheets" by 12 to 15 broker-dealers (Stipulation, No. 29; A-107-10).

The registration statement which included the stock of plaintiffs and their associates became effective on June 7, 1971. Several months before that date, however, plaintiffs and their associates had contacted Vincent Ross, a partner of Tobey & Kirk, and had requested that Tobey & Kirk handle the sale of their stock (Ross Transcript, pp. 28, 31; A-214, 217). They informed Mr. Ross that the stock was included in the registration statement and prior to the effective date of the registration statement, they furnished him with copies of the preliminary prospectus covering their shares (Stipulation, No. 3; A-100-1).

On or about June 3, 1971, the attorney for White Shield Corporation, George Solomon, sent a letter to the plaintiffs and the other selling stockholders named in the registration statement advising them that any broker-dealer participating in the distribution of more than 10% of the shares covered by the registration statement would be described in the prospectus as an "underwriter" within the meaning of the Securities Act of 1933. He further informed them that it was essential that he be notified promptly as to the identity of each such broker-dealer to be utilized in the sale of the shares and the number of shares which each selling stockholder had requested such broker-dealer to sell on behalf of the selling stockholder, even if that number was less than 10% of the total, because the same broker-dealer might be used by other selling stockholders. Mr. Solomon

advised plaintiffs and the other selling stockholders that the number of shares included in the registration statement covering their shares was 422,513, and that the number of shares included in another registration statement of White Shield Corporation was 850,000 (A-123, 161).

Although plaintiffs knew that they and their associates, Draddy and Pedersen, had requested Vincent Ross to sell 148,000 shares, which was well over 10% of the total number of shares being sold, they did not inform Mr. Solomon or White Shield Corporation of that fact. Accordingly, when the registration statement became effective on June 7, 1971, the prospectus did not identify Tobey & Kirk as an underwriter (Stipulation, No. 16; A-103-4).

It was not until June 14, 1971 that plaintiff Byrnes wrote to George Solomon to inform him that plaintiffs and their associates had sold through Tobey & Kirk an aggregate of 144,000 shares of White Shield Corporation (A-123, 162-3). On or about June 18, 1971, the White Shield prospectus was supplemented to identify Tobey & Kirk as a dealer who may be deemed an "underwriter" as that term is defined in the Securities Act of 1933 (A-104, 124).

Tobey & Kirk selected most of the purchasers of the White Shield stock which it sold for plaintiffs and their associates from the "Pink Sheets" (Stipulation, No. 11; A-103). The Pink Sheets showed the names of the broker-dealers who were making a market in the White Shield stock, i.e., regularly entering bid and ask quotations and purchasing and selling the stock as principal. Faulkner, Singer and Mitchum were each market-makers of the White Shield stock which regularly entered bid and ask quotations for the stock (Stipulation, Nos. 5-7; A-101-2).

Prior to June 7, 1971, Vincent Ross told plaintiff Santangelo that Faulkner was a buyer of the White Shield stock (Santangelo Transcript, p. 15; A-183). Santangelo telephoned Faulkner seeking a purchase of plaintiffs' stock

(Santangelo Transcript, p. 15; A-183). The trade was actually made between Faulkner and Tobey & Kirk, acting as agent for plaintiffs Santangelo and Byrnes (Stipulation, No. 4; A-101), the latter of whose identity was not known to Faulkner until after the trade (McMillen Transcript, pp. 75-6; A-310-11). Faulkner purchased the stock for its own account as principal (Stipulation, No. 9; A-102), and immediately after the trade resold 20,000 of the shares to Singer and to Mitchum at an aggregate mark-up of $1,875 (Stipulation, No. 25; A-106).

The two stock traders at Faulkner who participated in the transaction were named James McMillen and Ronald Lattuga. As will hereafter appear, at examinations before trial, McMillen testified that Santangelo did not inform him that the stock was included in a registration statement, and Lattuga testified that Santangelo represented that the stock was not so included. These facts are disputed by Santangelo.

The remaining stock sold by Tobey & Kirk on behalf of plaintiffs and their associates, including the stock sold to Singer, was sold directly by Tobey & Kirk (Stipulation, No. 5; A-101). Neither plaintiff had any discussions with Singer prior to the trade between Tobey & Kirk and Singer. The stock trader who participated in that transaction on behalf of Singer was named James Mullen. He knew, prior to June 8, 1971, that a "shelf registration" had been filed by White Shield Corporation. On that date, a trader at Tobey & Kirk telephoned him to offer shares of White Shield stock for sale to Singer. Mullen asked whether the stock was included in the "shelf registration"; the Tobey & Kirk trader said that it was not. Mullen accordingly purchased 1,500 shares of White Shield stock from that trader for Singer (A-75).

Although Tobey & Kirk had received copies of the preliminary prospectuses from plaintiffs prior to June 7, 1971 (Stipulation, No. 3; A-100-1), it did not distribute

any of those preliminary prospectuses to Faulkner or to any of the other purchasers of the White Shield stock from Tobey & Kirk (Stipulation, No. 19; A-105).

On June 7, 1971, Faulkner confirmed the trade with Tobey & Kirk by its usual confirmation or comparison form. That confirmation showed that Faulkner was making a market in the White Shield stock (Stipulation, No. 12; A-103). It did not indicate any agreement by Faulkner to purchase stock included in a registration statement (A-448). On that same day, Tobey & Kirk confirmed the sale to Faulkner. The Tobey & Kirk confirmation to Faulkner did not show that the stock was included in a registration statement.* Nor was that confirmation accompanied or preceded by a prospectus of White Shield Corporation (Stipulation, No. 13; A-103).

On June 15, 1971, the settlement date, Tobey & Kirk tendered delivery of the stock to Faulkner. A prospectus dated June 7, 1971 accompanied, but did not precede, that tender (Stipulation, No. 14; A-103). The prospectus showed that plaintiffs were selling stockholders whose stock had been registered (A-139). Faulkner accordingly rejected the stock (Stipulation, No. 14; A-103).

The fact that the stock was included in a registration statement, and was part of a distribution of White Shield stock, was significant because, as will hereinafter appear, Rule 10b-6 under the Securities Exchange Act of 1934, as interpreted by the Securities and Exchange Commission (the "S.E.C."), prohibits a market-maker from participating in a distribution of that security.

The White Shield prospectus also showed that a large amount of White Shield stock, more than 2,000,000 shares, was included in other registration statements of White Shield Corporation which had been filed with the S.E.C.

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*Section 10 of the Uniform Practice Code of the N.A.S.D., of which both Faulker and Tobey & Kirk were member firms, requires such information in the confirmation or comparison of the trade.

(A-141-2, 125, 129). Although the price of the White Shield stock (mean average bid and ask prices) had fallen to $12.34 on June 15, 1971 (A-73), Faulkner could not purchase White Shield stock in the open market to cover its resales to Singer and Mitchum, who were also market-makers of White Shield stock, because of the large amount of "distribution" stock in the market, which neither Singer nor Mitchum could lawfully trade. Faulkner had no White Shield stock in inventory at the time (A-454-5), and therefore cancelled its resales to Singer and to Mitchum, which cancellations were agreed to by the two purchasers (Stipulation, No. 26; A-106).

After Faulkner rejected the White Shield stock tendered by Tobey & Kirk on June 15, 1971, there were discussions among the parties concerning the dispute which had arisen therefrom. The last such discussion occurred on June 23, 1971, which was a telephone conversation in which Faulkner's in-house attorney confirmed to Mr. Ross that Faulkner could not accept the stock (Stipulation, No. 24; A-106).

Plaintiffs informed Mr. Ross that the problem was his and urged him to resolve it (A-93, 95). Plaintiffs regularly requested information from Mr. Ross as to the status of the matter. He told them that Tobey & Kirk's attorneys were negotiating with Faulkner in an attempt to resolve the dispute (A-168, 177). However, there were no such negotiations, that last conversation having occurred by the June 23, 1971 telephone call (Stipulation, No. 24; A-106). On or about August 9, 1971, Mr. Ross told the plaintiffs that the matter could not be resolved, at which time the plaintiffs instructed him to sell out the stock in the open market (A-168, 177).

Between June 15, 1971 and August 9, 1971, there were many broker-dealers bidding for the White Shield stock every day (Stipulation, No. 29; A-107). However, because Mr. Ross had informed plaintiffs that a resolution of the

dispute was being negotiated, plaintiffs made no attempt to resell the stock. By August 9, when they commenced selling the stock, the market price of the stock had dropped substantially (Stipulation, No. 29; A-107).

When those sales were made, neither plaintiffs nor Tobey & Kirk notified Faulkner that any of those sales were for its account or that plaintiffs would seek to hold Faulkner liable for the loss (Stipulation, No. 30; A-111). Plaintiffs contend that they sold out, through Tobey & Kirk, the stock rejected by Faulkner between August 9, 1971 and September 28, 1971, at prices ranging from \$9⅝ to \$7⅜ per share (Stipulation, No. 28; A-107).

The next event did not occur until July, 1972. That event was the commencement of an action in the Supreme Court of the State of New York, County of New York (the "State Court Action") on behalf of plaintiffs against Faulkner and Singer, in which plaintiffs sought to recover the difference between the respective contract prices with the defendants and the prices allegedly obtained for the stock on the sales to third parties in the open market (Stipulation, No. 31; A-111).

B. The Standards For Review

The summary judgment motions were made in lieu of a trial following the completion of pretrial discovery and upon an agreed statement of facts. Plaintiffs and Faulkner have each moved for summary judgment on those facts. Apart from Faulkner's first affirmative defense, as to which material facts are in dispute, all of Faulkner's remaining affirmative defenses presented for review can be determined as matters of law.

The rulings of the District Court on the summary judgment motions were made entirely upon papers, without any evidentiary hearing. It is therefore submitted that no special deference need be given to the rulings of the District Court, since this Court is in at least as good a position as

the District Court to read the Stipulation of Facts and other papers and to draw legal conclusions therefrom. See *S. E. C.* v. *Spectrum, Ltd.*, 489 F. 2d 535, 540 (2d Cir. 1973).

QUESTIONS PRESENTED

1. Does a purchaser of securities have any duty to inquire further into material facts where the sellers actually misrepresent those facts in response to the purchaser's inquiry?

2. Must a broker's confirmation to a dealer of a sale of securities in a registered offering being made by the broker's principals of which the broker has knowledge be preceded or accompanied by the prospectus where the sale is made within 40 days of the date the registration statement became effective?

3. Is a broker who sells securities included in a registered distribution and who purportedly receives usual and customary commissions from the owners, an "underwriter" as that term is defined in Section 2(11) of the Securities Act of 1933, where (a) the owners exercise registration rights obtained when they acquired their securities in a transaction exempt from the requirements of § 5 of the Securities Act of 1933 by reason of § 4(2) thereof, and upon such exercise include their securities in a registered distribution by the issuer and other selling stockholders, (b) the securities are sold by the broker in three days for approximately $2,000,000 to a group of dealers which purchase them for resale to the public, (c) the amount of securities sold by the broker exceeds 10% of the amount of securities included in the registered distribution, and (d) the broker agreed to undertake to make such sales with knowledge of the foregoing facts?

4. May sellers of securities in a registered offering recover on a contract of sale of the securities against a pur-

chaser who refuses to accept delivery, where the prospectus fails to disclose a material fact but the omission was purportedly made in accordance with a practice accepted by the S.E.C.?

5. Does a dealer which makes a market in a security and which purchases and sells securities which are part of a distribution of those securities become a participant in that distribution within the meaning of Rule 10b-6 promulgated under the Securities Exchange Act of 1934?

6. May a party who acts in compliance with an administrative regulation, as interpreted by the administrative agency, where its failure to do so would subject it to civil and criminal sanctions, be held liable therefor to another party for breach of contract in a civil action in which the agency's interpretation of its regulation is overruled?

7. Must a purchaser of securities in an offering registered under the Securities Act of 1933 be given a reasonable time after first receiving the prospectus to read it before becoming legally bound on its purchase agreement?

8. May owners of securities sold but rejected by the purchaser, who fail to liquidate the contract and sell-out the securities within a reasonable time, recover damages measured by the eventual resale prices, rather than lesser damages measured by the market price at the time and place for performance?

9. May owners of securities sold by a broker to a dealer and rejected by the dealer recover the full amount of their loss where the broker fails to liquidate the sale in accordance with the rules of the N.A.S.D., of which both the selling broker and purchasing dealer are members?

10. May a defrauded purchaser of securities maintain a claim against the sellers under Rules 10b-5 and 10b-6

promulgated under the Securities Exchange Act of 1934 and under New York law, where, based upon the market price, the purchaser would not have sustained damages, but where the market price used to measure the damages was manipulated by the sellers?

POINT I

THE DISTRICT COURT PROPERLY DENIED PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT ON FAULKNER'S FIRST AFFIRMATIVE DEFENSE

By Faulkner's first affirmative defense and third counterclaim, Faulkner has asserted that plaintiffs falsely represented and failed to disclose several material facts to Faulkner: first, they falsely represented to Faulkner that the stock to be purchased by Faulkner was not part of a registered distribution; second, they failed to disclose that Tobey & Kirk was an underwriter; and third, they failed to disclose that they were selling the stock to market-makers. The materiality of these matters appears from the discussion of Faulkner's fourth affirmative defense (Point IV, *infra*). The District Court denied plaintiffs' motion for summary judgment on Faulkner's first affirmative defense because of disputed factual contentions.

Faulkner's stock traders, Ronald Lattuga and James McMillen, each testified that in connection with the transaction, Santangelo represented that the stock being sold was not included in a registration statement. McMillen testified that Santangelo had informed him that "clearance" was required by the S.E.C. before he could sell the stock, but when McMillen inquired whether the stock was included in a registration statement, Santangelo advised him that it was not (Transcript of Deposition of James McMillen, as a witness, June 4, 1973, at pp. 13, 51-52, 66-68; A-268, 297-8, 307-9). Lattuga testified similarly (Transcript of Deposition of Faulkner by Ronald J. Lattuga, June 21, 1973, at pp. 18-19; A-361-2).

Plaintiffs' erroneous conclusion that there is no genuine issue of any material fact with respect to Faulkner's first affirmative defense is based upon several erroneous premises: first, they contend that the testimony of the participants in the relevant conversations refutes Faulkner's claims of fraud; second, they contend that Faulkner had a "duty of inquiry" to ascertain the relevant facts, which presumably excuses plaintiffs' failure to disclose them; and third, they assume that the Court may assess the credibility of the participants in the various conversations on a summary judgment motion and resolve the issues of fact against Faulkner.

A. The Telephone Conversations Leading to the June 7 Trade

All of the participants in the telephone conversation on June 7, 1971 between Vincent Ross, Francis Santangelo and James McMillen, in which Tobey & Kirk sold 44,000 shares of White Shield to Faulkner at $14.00 per share, are in substantial agreement as to the substance of that conversation, in which the registration statement was not mentioned (Transcript of Deposition of Francis R. Santangelo in the State Court Action, January 12, 1973, pp. 18-19; A-186-7; Transcript of Deposition of Tobey & Kirk by Vincent C. Ross, Jr., May 11, 1973, p. 100; A-245; McMillen Transcript, p. 31; A-286). However, significant differences appear with respect to prior conversations.

Thus, Lattuga testified that he asked Santangelo whether the stock being offered to Faulkner was part of "the" or "any" secondary, and Santangelo replied that it was not. Lattuga never mentioned the registration statement of White Shield Corporation for the stock offering to be underwritten by Leason & Co., Inc. (Exhibit 2 to plaintiffs' Notice of Motion for summary judgment; A-135) which had been discussed between Santangelo and

McMillen (Lattuga Transcript, pp. 15-19, 39; A-358-62, 373). Santangelo however, testified that he had no recollection of ever having spoken to Lattuga (Santangelo Transcript, pp. 16-17; A-184-5).

McMillen testified that his first conversation with Ross was on June 7—the conversation in which the trade was made (McMillen Transcript, p. 31; A-286)— and that Ross never offered him a "red herring" or preliminary prospectus (McMillen Transcript, p. 86; A-317). Ross claims he spoke to McMillen prior to the trade date, told him that the stock was in registration and, either prior to or on the trade date, offered him a copy of the preliminary or "red herring" prospectus (Ross Transcript, p. 93; A-240). However, Ross also testified that a "red herring" prospectus was not delivered to Faulkner or to any of Tobey & Kirk's purchasers (Ross Transcript, pp. 49-50; A-230-1; Stipulation, No. 19; A-105).

Plaintiffs quote a portion of McMillen's testimony wherein the phrase "in registration" was used, to suggest that McMillen "admitted" he understood the stock "might be" part of a registered distribution (Pltfs' Brief, pp. 77-8).* However, McMillen is a layman and had only a very general understanding of the legal terminology of the securities laws. A review of the transcript of his testimony makes it clear that his understanding was geared to the sort of problem he encountered in his work. He would try to discover whether the stock he was buying could legally be resold. It is clear from his testimony both in the passage quoted and elsewhere that he understood the term "in registration" used in his examination (***but not used in his*** *conversations with Santangelo*) to mean nothing more specific than awaiting "SEC clearance" (McMillen Transcript, p. 107; A-336). "SEC clearance" meant any Commission action which freed stock for sale by its owner. It could

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*References to plaintiffs' brief submitted on their appeal appear herein as "Pltfs' Brief".

mean a no-action letter with regard to the sale of unregistered stock or other termination of restrictions against sale (McMillen Transcript, pp. 18-23; A-273-8; corrections and changes to deposition of James McMillen, sworn to January 26, 1975; A-349-50). McMillen, like Lattuga, was concerned lest the stock purchased be in any way restricted against sale or resale. Of this he inquired, only to receive an answer at best misleading.

B. The Telephone Conversation on or About June 14, 1971

Lattuga testified that after the trade, he heard that Tobey & Kirk was selling White Shield stock "all over the street" and called Tobey & Kirk on June 14, 1971, the day prior to the settlement date, to determine whether the shares Faulkner had purchased were part of a secondary; that Vincent Ross said "no", they were part of an "uncoordinated wraparound secondary"; that Lattuga asked Ross what that meant, to which Ross replied he didn't know; that Lattuga asked whether the stock would be accompanied by a prospectus; and that Ross replied "no, but if you want one, I'll send it" (Lattuga Transcript, pp. 55, 78-9; A-386, 395-6). Ross admitted this conversation (Ross Transcript, pp. 103-4; A-248-9) and stated that he had been informed by the company (White Shield) that "this was not a shelf registration . . . ."

McMillen had testified that Santangelo had told him, prior to the trade, that Santangelo had some registered stock, but the stock being sold to Faulkner was not part of the registered stock (McMillen Transcript, pp. 81-3; A-313-5), and that it was owned by another group that he belonged to (McMillen Transcript, p. 13; A-268).*

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*This would refute plaintiffs' argument that had Faulkner obtained the prospectus naming Santangelo and subtracted the number of shares being sold thereby from the number he owned, Faulkner would have realized that the stock it was purchasing must be included in that prospectus (Pltfs' Brief, p. 65).

The very fact that this June 14 telephone conversation occurred is inconsistent with plaintiffs' version of the prior communications. Even though Faulkner's traders testified that they had been informed by Santangelo prior to the trade that the stock being purchased was not part of the secondary to be distributed (admittedly, they only knew of one registration statement filed by White Shield, which registered the Leason & Co. offering), it was quite natural, upon hearing a rumor after the trade that Tobey & Kirk was selling large blocks of stock to other market-makers, to verify the status of the stock Faulkner had purchased from Tobey & Kirk.

However, it would be quite unnatural for this call to have been made if in fact Faulkner's traders had been informed, prior to the sale, that the stock being offered to Faulkner was part of a secondary. If, as plaintiffs contend, Faulkner's traders had been informed prior to the trade on June 7 that the stock being offered was part of the secondary distribution, why would Lattuga have telephoned Ross after the trade to ask this question? And if Ross had given Faulkner such information prior to the trade, why would he not have said so instead of answering Lattuga with language which imparted no meaningful information at all?

Plaintiffs seek to minimize the significance of this conversation by arguing that what Lattuga was inquiring into just before the settlement date was a rumor that Tobey & Kirk was selling *unregistered* White Shield stock, rather than stock in a secondary distribution as testified (Pltfs' Brief, pp. 79-80). In so doing, plaintiffs ignore the fact that Lattuga testified he did not use the term "unregistered" in its legal sense, but meant by the term stock which Faulkner could not lawfully sell (Lattuga Transcript, p. 50; A-381). Moreover, the word "unregistered" was used in a memorandum of Lattuga (prepared two weeks to one month after the transaction—Lattuga Transcript, pp. 39-40; A-373-4), admittedly incorrectly, and *not* in his conversations with

Santangelo or Ross. Further, plaintiffs' conclusion that Lattuga was inquiring about unregistered stock is squarely contradicted by the testimony of both participants in the post-trade conversation, Mr. Lattuga and Mr. Ross.

C. The Questions of Credibility and Motivation

Plaintiffs' Brief is replete with characterizations concerning the veracity of the witnesses, *e.g.,* that Santangelo had not "intended to be understood" as having said his stock was not part of a secondary (Pltfs' Brief, p. 66), that his response was not "calculated to deceive" and was made "in good faith" (Pltfs' Brief, p. 76), but that Lattuga's testimony was "obviously slanted" (Pltfs' Brief, p. 80). Plaintiffs simply overlook the fact that the Court cannot assess the credibility of witnesses on a summary judgment motion. *Cross* v. *United States,* 336 F. 2d 431 (2d Cir. 1964); *Hirsch* v. *Archer-Daniels-Midland Company,* 258 F. 2d 44 (2d Cir. 1958).

With respect to the question of credibility, it should also be pointed out that, on the basis of the record, neither plaintiffs nor Tobey & Kirk have any credibility at all. Thus, as set forth above, unlike the testimony of Faulkner's representatives, the testimony of plaintiffs and Ross is contradictory and patently self-serving. Moreover, as will be seen in the discussion of Faulkner's seventh affirmative defense (Point VI, *infra*), plaintiffs have admitted that Ross deceived them concerning alleged discussions with Faulkner between June 23 and August 9, 1971.

Further, James Mullen, a stock trader employed by Singer, unequivocally stated in an affidavit sworn to May 3, 1973 (A-74-5), which was submitted in opposition to plaintiffs' earlier motion for summary judgment, that he specifically inquired of Tobey & Kirk's stock trader on June 8, 1971 whether White Shield stock being offered to Singer was included in the "shelf" registration and was told it was not so included. The fact is, as plaintiffs acknowledge, that it was so included. The facts in that affidavit have

never been disputed or contradicted by plaintiffs or by Tobey & Kirk.

Additionally, Vincent Ross, as will hereinafter appear, has evidenced a complete disregard of the requirements of the federal securities laws and any obligation of candor, and has done so on other occasions. See Securities Exchange Act Release No. 10531, November 29, 1973 (consent order on findings that Mr. Ross wilfully sold unregistered stock, and thereafter made false bookkeeping entries to conceal payments made by the purchasers).

Moreover, the documentary record supports the testimony of Faulkner's traders and is inconsistent with the testimony of Santangelo. It has been agreed that a prospectus was not delivered to Faulkner with Tobey & Kirk's confirmation of the sale, or prior thereto (Stipulation, No. 13; A-103). It has also been agreed that "red herring" prospectuses (preliminary prospectuses) were not delivered to Faulkner or any other purchaser of the White Shield stock from Tobey & Kirk, although they were in the possession of Tobey & Kirk (Stipulation, Nos. 3, 19; A-100-1, 105).

Further, the Tobey & Kirk confirmation of the sale transmitted to Faulkner on or about June 7, 1971, does not disclose that the stock was registered stock, although such disclosure was required by Rules of the N.A.S.D. (Stipulation, No. 13; A-103). Nor does the Faulkner confirmation of the trade sent to Tobey & Kirk show any agreement by Faulkner to purchase stock included in a registration statement (A-448).

Apart from plaintiffs' self-serving assertions as to oral communications, the entire record shows an agreement by Faulkner to purchase freely tradeable stock, and that it was not informed that the stock it had agreed to purchase was part of a registered distribution. Thus, even if the Court could assess credibility on a summary judgment motion, on the basis of the record, it is respectfully submitted that any

of the issues to be determined on the basis of credibility can only be resolved against plaintiffs and Tobey & Kirk.

Moreover, although plaintiffs have repeatedly attempted to impute improper motives to Faulkner for its decision to cancel the trade (which is not relevant in any event, in view of its illegality), these attempts are based upon misleading assertions. Thus, plaintiffs suggest Faulkner cancelled the transaction to avoid a loss, and state that between the trade date and the settlement date "the market price of the White Shield stock had declined sharply" (Pltfs' Brief, p. 3). On the contrary, as will appear in connection with the discussion of Faulkner's seventh affirmative defense, the price had only declined from $14 to $12.34. Moreover, Faulkner had resold 20,000 of the 44,000 shares at a slight profit. Hence, performance of the contract would not have had a substantial economic consequence to Faulkner.

On the other hand, the loss to Faulkner in unjustifiably cancelling a contract would have been great. Its trading operations were and are based upon its reputation. It made and obtained commitments every day based upon its word alone. The consequences of an unjustified repudiation of an oral commitment by a broker-dealer whose business is based upon oral commitments are obvious. Faulkner cancelled the transaction because it was unlawful, and for no other reason.

Plaintiffs also repeatedly suggest that after the cancellation Faulkner's decision to revoke or affirm it vacillated with the market prices of the stock (Pltfs' Brief, pp. 85-6, 87-8, 94). That suggestion is also unsupported by the record. Faulkner was resolute in its position that it could not be a party to an unlawful agreement, and the parties have so stipulated (Stipulation, Nos. 21-24; A-105-6).

Parenthetically, plaintiffs' analysis of the motivations of the parties does not comport with facts in the record which are not disputed. Why did Tobey & Kirk's confirmation to Faulkner not disclose that the stock was registered

stock? Why was that confirmation not accompanied by a prospectus? Why did Tobey & Kirk similarly misrepresent the status of the stock to Singer? The answers support only one conclusion: plaintiffs and Tobey & Kirk had a large block of distribution stock which they wanted to "dump" on the market and avoid the competition from many other sellers of White Shield stock; to effectuate that purpose, for reasons which will become apparent from the discussion of Faulkner's fourth affirmative defense (Point IV, *infra*), they failed to inform their purchasers of the status of the stock; and when questions were asked, evasive and misleading responses were given.

Santangelo says that the precise question which McMillen had asked of him was whether the stock was part of the Leason secondary, and that Santangelo had truthfully answered that it was not (Santangelo affid., ¶ 4; A-175-6). Plaintiffs argue that when Lattuga asked Santangelo whether the stock was included in "the" secondary, Santangelo had the right to assume that that inquiry was predicated on the earlier conversation with McMillen; that "the" secondary was the "Leason secondary" (which in fact was not a secondary at all) (Solomon affid., ¶ 2(b); A-120-1), and truthfully answered that it was not. Santangelo says that he correctly answered the specific questions asked in the way that he interpreted them, and had no understanding of their significance, since he had no knowledge of the decision in *Matters of Jaffee & Co., et al.*, 44 S.E.C. 285 (1970), C C H Fed. Sec. L. Rep. [1969-70 Transfer Binder] ¶ 77,805, *aff'd in part on other grounds, Jaffee & Co.* v. *S.E.C.*, 446 F. 2d 387 (2d Cir. 1971) (Santangelo affid., ¶¶ 4, 6; A-175-7).*

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*Plaintiffs' purported ignorance of the law is not a valid justification for any of the violations of the federal securities laws in which they participated. See *Jaffee & Co.* v. *S.E.C.*, 446 F. 2d 387, 391-2 (2d Cir. 1971); *United States* v. *Wolfson*, 405 F. 2d 779 (2d Cir. 1968), *cert. den.*, 394 U. S. 946 (1969).

It is submitted that Santangelo, a specialist on the American Stock Exchange (Santangelo affid., ¶ 6; A-176), and Tobey & Kirk, a broker-dealer, knew very well the significance of the fact that the stock was part of a registered distribution, that it was because of that knowledge that they hastily completed their distribution by concealment and misrepresentations of the status of the stock, and that even if plaintiffs' version of the conversations were true, the imprecise inquiries of McMillen and Santangelo's self-serving interpretation of Lattuga's inquiries would not justify plaintiffs' failure to disclose the fact that plaintiffs' stock was part of a registered distribution. On this record, plaintiffs' protestations of innocence ring hollow.

Indeed, these facts bring into focus the fatal infirmity of plaintiffs' entire claim: this action was commenced against the wrong broker. Why did plaintiffs not sue Tobey & Kirk, which admittedly (1) failed to deliver a prospectus to Faulkner with the confirmation of sale, (2) sold the stock to market-makers, (3) deceived plaintiffs about alleged negotiations concerning a possible resolution of the dispute, and (4) failed to comply with the N.A.S.D. Rules, each of which transgressions precludes plaintiffs from recovering on their claim against Faulkner? It is submitted that the means and method of the distribution of the White Shield stock were devised jointly by plaintiffs and Tobey & Kirk. What other possible reason could plaintiffs have had for relinquishing an otherwise meritorious and easily-proved claim against their own broker in favor of pursuing this claim against Faulkner?

It is submitted that the record refutes the excuses offered by plaintiffs for their conduct and the motivations they would ascribe to Faulkner. The record supports only one conclusion: a wilful plan by plaintiffs and Tobey & Kirk to distribute the White Shield stock in violation of the federal securities laws, attended by deliberate concealment and misrepresentations.

In any event, for the reasons set forth above, these questions of credibility and motivations cannot be resolved on a motion for summary judgment.

D. The Alleged Duty of Inquiry

Notwithstanding the established principles of law which require full and fair disclosure by a seller in securities transactions, plaintiffs erroneously contend that Faulkner had a duty to inquire and ascertain the facts. Apparently seeking to resurrect the rule of *caveat emptor,* plaintiffs' proffer the novel proposition that Faulkner had a duty to attempt to obtain a copy of the red herring prospectus (which plaintiffs and Tobey & Kirk admittedly failed to deliver to Faulkner—Stipulation, No. 19; A-105), which would have given Faulkner all of the facts. And this proposition is made even though Faulkner's traders say they made specific inquiries as to the status of the stock, and were given assurance that it was not part of the secondary.

Plaintiffs are in error. It has long been settled that the seller of a security has a duty to fully and fairly disclose material facts to the purchaser. As the Supreme Court said in *Affiliated Ute Citizens of the State of Utah* v. *United States,* 406 U. S. 128 (1972):

> ". . . the 1934 Act and its companion legislative enactments [footnote omitted] embrace a 'fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.' S.E.C. v. Capital Gains Research Bureau, 375 U. S. 180, 186, 11 L. Ed. 2d 237, 243, 84 S Ct 275 (1963)." 406 U. S. at 151

Moreover, as will hereinafter appear, Faulkner's first affirmative defense also sets forth a defense based upon § 12(2) of the Securities Act of 1933, 15 U. S. C. § 771(2).

Under that statute, it has been held that the purchaser has no duty of inquiry whatsoever.

Stripped to its essentials, plaintiffs' contention is that although plaintiffs and Tobey & Kirk were well aware of the two facts which would have made consummation of the sale illegal—Faulkner's status as a market-maker and the fact that plaintiffs were tendering distribution stock—plaintiffs were not required to disclose the latter fact to Faulkner unless Faulkner correctly identified to them by name the distribution in which the stock was included. And, contend plaintiffs, Faulkner should have been familiar with this distribution by reference to the prospectus for the Leason distribution of which plaintiffs had assured Faulkner the securities they were selling to Faulkner were not a part.

The cases which plaintiffs cite for this untenable proposition (Pltfs' Brief, Point IV) fall into two categories: those which are inapposite and those which in fact refute plaintiffs' contention. These cases stand for the general proposition that a party to a securities transaction need not disclose routine data to the other party, where that information is readily available to the latter.

In the present case, the fact that the particular shares being offered to the defendants were part of a distribution was a material fact, and was peculiarly within the knowledge of plaintiffs. According to the testimony of Faulkner's traders, the fact that the shares being offered to Faulkner were part of a secondary distribution was not merely concealed but *was actually misrepresented* to Faulkner when Faulkner specifically inquired whether the stock was part of a secondary distribution.

Any putative duty of inquiry was most certainly discharged when Lattuga's questions were answered directly on point. Yet plaintiffs evidently contend that there was incumbent on Faulkner a duty not to accept Santangelo's response but to make further inquiries, and that each such

inquiry should have been pursued flawlessly lest Faulkner forfeit its rights.

Plaintiffs say that Faulkner should have obtained the Leason prospectus (which Santangelo had stated did *not* pertain to the shares offered); that in the Leason prospectus Faulkner would have seen references to other prospectuses; that Faulkner should then have obtained and read these other prospectuses; that in one of these other prospectuses, Faulkner would have seen a page with the name of Santangelo (and Byrnes' name as well, which had never even been mentioned); thus, say plaintiffs, Faulkner would have been on notice that it was purchasing distribution stock, notwithstanding the fact that Santangelo had told Lattuga that the stock to be sold to Faulkner was not part of any secondary distribution.

In *Metro-Goldwyn-Mayer, Inc.* v. *Ross,* 509 F. 2d 930, 933 (2d Cir. 1975), the Court stated that a duty to disclose "is not discharged merely by giving the purchaser access to company records and letting him piece together the material facts if he can." In *Dale* v. *Rosenfeld,* 229 F. 2d 855, 858 (2d Cir. 1956), a prospectus conveyed the impression that an offering was the subject of a "firm commitment" underwriting. However, the prospectus actually invited purchasers to inspect a copy of the underwriting agreement. Inspection would have readily revealed that the underwriters promised only their "best efforts". Nevertheless, the Court found that defendants had failed to discharge their duty of disclosure and that plaintiff had not failed in any duty of inquiry, stating "we cannot agree that due diligence required an examination of the underwriting agreement." As the Court stated:

> "Availability elsewhere of truthful information cannot excuse untruths or misleading omissions in the prospectus. 'Readiness and willingness to disclose are not equivalent to disclosure.' [citation omitted]" 229 F. 2d at 858.

Plaintiffs here have not even demonstrated the "readiness and willingness to disclose" held legally insufficient in *Dale* v. *Rosenfeld.* To the contrary, plaintiffs here, whether by reason of alleged ignorance of the law or otherwise, made actual misrepresentations as to the status of the stock being sold to Faulkner, so that even if Faulkner had followed the trail of prospectuses and found that one with Santangelo's name, it would nevertheless not have been on notice that the stock it was purchasing was included in that prospectus, in view of the explicit response by Santangelo to Lattuga's inquiries as set forth above.

E. The Applicable Legal Standards

Plaintiffs contend (Pltfs' Brief, pp. 63, 66) that any misinformation given to Faulkner's traders was not deliberate, since plaintiffs say they had no knowledge of the *Jaffee* decision, hereinafter discussed, and thus did not understand the significance of the questions being asked by Faulkner's traders (Santangelo affid., ¶¶ 4, 6; A-175-7). Ross testified similarly (Ross Transcript, p. 111; A-256). Plaintiffs thus suggest that because of their ignorance of the law, the failure to disclose the relevant facts was unintentional.

Even if plaintiffs were correct that there was no intent to deceive, Faulkner was nevertheless entitled to rescind the transaction, because a right to rescind does not depend on a showing of actual fraud or intent to deceive. A right to rescind a securities transaction (as opposed to a right to sue for damages) arises even where a misstatement or nondisclosure of a material fact *is entirely innocent. S.E.C.* v. *Texas Gulf Sulphur Co.,* 401 F. 2d 833, 845-55 and nn. 21, 22 (2d Cir. 1968), *cert. denied,* 394 U. S. 976 (1969).

Further, the allegations of Faulkner's first affirmative defense establish under § 12(2) of the Securities Act an absolute defense to plaintiffs' claim. The fact that that

statute is not mentioned in Faulkner's first affirmative defense is not relevant, since the facts giving rise to the defense under § 12(2) are alleged. Under that section, reliance upon a seller's misrepresentation or nondisclosure is not an element of the defense. *DeMarco* v. *Edens,* 390 F. 2d 836, 841 (2d Cir. 1968). Nor need a purchaser demonstrate *scienter* on the seller's part. *Johns Hopkins University* v. *Hutton,* 297 F. Supp. 1165, 1219 (D. Md. 1968), *aff'd in part, rev'd in part on other grounds,* 422 F. 2d 1124 (4th Cir. 1970), *cert. denied,* 416 U. S. 916 (1974). Nor may a purchaser's lack of diligence or contributory negligence in failing to discover the facts misrepresented or not disclosed defeat the defense. It is only the purchaser's *actual knowledge* which may defeat it. *American Bank & Trust Company in Monroe* v. *Joste,* 323 F. Supp. 843, 847 (W.D. La. 1970) (seller misrepresented that he was selling registered stock); *Johns Hopkins, supra,* at 1221-1222.

F. The Failure to Disclose that Tobey & Kirk was an Underwriter

In addition to the misrepresentations and nondisclosures set forth above, Faulkner was never informed by either Tobey & Kirk or by plaintiffs that Tobey & Kirk was acting as an underwriter as that term is defined in either the Securities Act of 1933 or in Rule 10b-6 promulgated pursuant to the Securities Exchange Act of 1934. Nor was Faulkner informed of the facts from which it might have been able to infer what plaintiffs have termed the "legal conclusion" that Tobey & Kirk was an underwriter, namely, that Tobey & Kirk was selling not only for Santangelo, but for Byrnes, Pedersen and Draddy, and that all of the stock it was selling was included in a registration statement (see Stipulation, Nos. 1-3; A-100-1).

Faulkner knew that the stock to be sold by Santangelo was being sold for a group of which Santangelo was a member, but never heard the name Byrnes until after the

trade (McMillen Transcript, pp. 14, 75-6; A-269, 310-11). And the names of Draddy and Pedersen were unknown to Faulkner until they were disclosed at Santangelo's deposition in the State Court Action. Even plaintiffs do not argue that Faulkner knew these facts, and in fact the record and plaintiffs' version of the conversations among the parties shows the contrary. And on the basis of the information which Faulkner did have, Faulkner could not have concluded that Tobey & Kirk was an underwriter.

The factors which establish that Tobey & Kirk was an underwriter as defined in the Securities Act of 1933 are set forth hereinafter in Faulkner's discussion of its third affirmative defense (Point III, *infra*). And Tobey & Kirk was likewise an underwriter as defined in Rule 10b-6,* the materiality of which becomes apparent from the discussion of Faulkner's fourth affirmative defense (Point IV, *infra*).

Moreover, the so-called duty of inquiry which plaintiffs would impose on Faulkner would not, even if fastidiously exercised as plaintiffs suggest, have uncovered this fact, since the prospectus at the end of the trail did not disclose it.

G. The Failure to Disclose the Method of Distribution

Plaintiffs also failed to disclose the method in which their White Shield stock was being distributed. Based upon plaintiffs' version of the conversations among the parties, plaintiffs admittedly never disclosed that their stock was being sold to market-makers, which, as will hereinafter appear, constituted a manipulative distribution of the stock. Indeed, plaintiffs contend they did not even know the significance of such a fact (Santangelo affid., ¶¶ 4, 6; A-175-7). Mr. Ross professed to share this ignorance (Ross Tran-

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*Rule 10b-6(c)(1) defines the term "underwriter" as "a person who has agreed with an issuer or other person on whose behalf a distribution is to be made (A) to purchase securities for distribution or (B) to distribute securities for or on behalf of such issuer or other person or (C) to manage or supervise a distribution of securities for or on behalf of such issuer or other person."

script, p. 111; A-256). Had such a disclosure been made, Faulkner certainly would not have agreed to purchase any of the stock, and it is highly unlikely that any of the other purchasers making a market in the stock would have purchased any of the stock; they would each have realized that by a purchase, they would be "participating in a distribution," a concept hereinafter discussed (Point IV, *infra*).

In *S.E.C.* v. *Resch-Cassin & Co., Inc.*, 362 F. Supp. 964 (S. D. N. Y. 1973), wherein an underwriter who had engaged in a distribution of securities was found to have employed market-makers in an illegal manipulative scheme to enable it to complete its distribution quickly, the Court said:

> "Rule 10b-6 defines certain conduct as manipulative *per se.* No further showing of manipulative intent is required to establish violations of the rule. The relevant portion herein is paragraph (a)(3), *supra,* which provides that a dealer who is participating in a distribution may not bid for or purchase the stock being distributed until after he has completed his part in the distribution." 362 F. Supp. at 980.

Accord, Jaffee & Co. v. *S.E.C.*, 446 F. 2d 387, 391 (2d Cir. 1971).

The Court in *Resch-Cassin* found that the failure to disclose this manipulative scheme to a purchaser was a further violation of Section 10(b) and of Rule 10b-5:

> " . . . the defendants were engaged in a manipulation of the price of that stock and were under a duty to inform the purchasers that no attention should be paid to the market price in considering whether or not to complete the purchases." 362 F. Supp. at 979.

Accord, Matter of Collins Securities Corp. et al., S.E.C. Release 34-11766, CCH Fed. Sec. L. Rep. [1975-76 Transfer Binder] ¶ 80,327 at p. 85,798.

Plaintiffs apparently acknowledge that a seller must disclose to his purchaser a "conventional" market manipulation, but attempt to excuse this nondisclosure by suggesting that the manipulation concealed was not "conventional" (Pltfs' Brief, fn. on p. 4). This argument has elsewhere received the short shrift it deserves. In *A. T. Brod & Co.* v. *Perlow,* 375 F. 2d 393, 397 (2d Cir. 1967), the Court stated:

> "We believe that § 10(b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws." (emphasis supplied by the Court)

See also *Superintendent of Insurance* v. *Bankers Life & Casualty Co.,* 404 U. S. 6, 10 n. 7 (1971); *Schlick* v. *Penn-Dixie Cement Corp.,* 507 F. 2d 374, 379 (2d Cir. 1974), *cert. denied,* 421 U. S. 976 (1975).

Faulkner was not required to demonstrate a manipulative effect in order for plaintiffs' failure to disclose their manipulative practices to be actionable. It is Faulkner's position that plaintiffs' manipulation caused the market price for White Shield stock to be artificially inflated, as evidenced by the market trend during and after the distribution.

Moreover, whether or not manipulative practices succeed in having a manipulative effect is immaterial to a claim of nondisclosure. The existence of manipulative practices—which immediately render the market suspect as an indicator of value—is a material fact which must be

disclosed to a prospective purchaser, whose decision may certainly be affected thereby. See *S.E.C.* v. *Resch-Cassin & Co., Inc., supra.*

Plaintiffs do not dispute that they and Tobey & Kirk failed to disclose to Faulkner the fact that plaintiffs' White Shield stock was being distributed by Tobey & Kirk through market-makers.* Nevertheless, they attempt to minimize its significance by not even discussing it in their Brief.

Thus, whether or not plaintiffs had knowledge of Rule 10b-6 or the *Jaffee* decision, they did fail to disclose an intent to engage in manipulative practices illegal *per se.* On the basis of this point alone, Faulkner is entitled to summary judgment. And Faulkner is entitled to summary judgment even though it did not move for summary judgment on its first affirmative defense. *Briscoe* v. *Compagnie Nationale Air France,* 290 F. Supp. 863, 867 (S. D. N. Y. 1968); *Time Incorporated* v. *Bernard Geis Associates,* 293 F. Supp. 130, 133 (S. D. N. Y. 1968). See also, *Local 33, International Hod Carriers, etc.* v. *Mason Tenders, etc.,* 291 F. 2d 496, 505 (2d Cir. 1961).

For the foregoing reasons, it is submitted that plaintiffs' motion for summary judgment on Faulkner's first affirmative defense was completely without merit and was properly denied.

POINT II

THE DISTRICT COURT PROPERLY GRANTED SUMMARY JUDGMENT TO FAULKNER ON ITS SECOND AFFIRMATIVE DEFENSE

By Faulkner's second affirmative defense, it has been asserted that plaintiffs are precluded from any right of recovery because Tobey & Kirk's confirmation of the trans-

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*The inquiry which plaintiffs suggest Faulkner should have made pursuant to the duty they would impose on Faulkner would not have uncovered the method of distribution through market-makers, since the prospectus did not disclose it.

action to Faulkner on or about June 7, 1971 was not accompanied by or preceded by a prospectus meeting the requirements of § 10(a) of the Securities Act of 1933 (15 U. S. C. § 77j(a)), so that the transaction was unlawful *per se* under § 5 of the said Act (15 U. S. C. § 77e). There is no issue of fact with respect to this affirmative defense. (Stipulation, Nos. 13, 14; A-103), and the District Court granted summary judgment thereon to Faulkner.

As set forth above, Mr. Ross of Tobey & Kirk testified that a prospectus was not sent to Faulkner with or prior to Tobey & Kirk's confirmation (comparison) of the sale on or about June 7, 1971 as required by law (Ross Transcript, pp. 42-43; A-227-8).

Faulkner admittedly did not have a copy of any red herring or preliminary prospectus of White Shield (Plaintiffs' Rule 9(g) Statement, ¶ 14; A-204). A prospectus was sent to Faulkner with the stock on the settlement date, June 15, 1971, but not prior thereto (Stipulation, Nos. 13, 14; A-103-4).

However, the delivery of a prospectus after the delivery of a confirmation does not cure the failure to deliver a prospectus with the confirmation, which provides a complete defense to plaintiffs' claim. Thus, Securities Act Release No. 33-4697 (June 5, 1964), CCH Fed. Sec. L. Rep. ¶ 3260, includes the following language:

> "When the registration statement becomes effective, oral offerings may continue and sales may be made and consummated. *A copy of the final statutory prospectus must be delivered in connection with any written offer or confirmation or upon delivery of the security, which ever first occurs.*" (emphasis added)

Moreover, because the confirmation was not accompanied by a prospectus, the confirmation itself became a "pro-

spectus" as defined in § 2(10) of the Securities Act of 1933 (15 U. S. C. § 77b(10)), so that the sale to Faulkner was unlawful *per se* by reason of § 5(b)(1) of that Act. Accordingly, Faulkner had an absolute right to rescind the transaction, pursuant to § 12(1) of the Securities Act of 1933 (15 U. S. C. § 771(1)), which Faulkner did in fact do.

Although plaintiffs have attempted to excuse the failure to deliver a prospectus to Faulkner on the ground that a confirmation from one broker to another is sometimes called a "comparison", there is no difference between a "confirmation" and a "comparison", nor has research disclosed any legal support for any distinction between the two.*

The term "prospectus" is defined by § 2(10), in relevant part, as follows:

> "(10) The term 'prospectus' means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or *confirms the sale of any security*. . ." (emphasis added)

Hence, it is clear that Tobey & Kirk's confirmation of the sale was a "prospectus" as defined by § 2(10), and its transmittal unaccompanied by a prospectus meeting the requirements of § 10(a) of the 1933 Act violated Section 5 of that Act, so that Faulkner was entitled to rescind the transaction. See 1 L. Loss, Securities Regulation 247 (2d ed. 1961).

Thus, an article entitled "Section 5 Fundamentals" appearing in the New York Law Journal dated February

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*The rejection of plaintiffs' purported distinction by the S.E.C. in its *amicus* brief filed with the District Court should be determinative, unless this Court finds that the position of the *amicus* was "clearly unnatural or unreasonable." *Perine* v. *William Norton & Co.*, 509 F. 2d 114, 120 (2d Cir. 1974)

10, 1975 (p. 1, col. 1), by Ezra Weiss, formerly chief counsel of the Division of Trading and Markets of the Securities and Exchange Commission and more recently serving as legal advisor to the Division of Market Regulation, includes the following (p. 5, col. 1):

> "To complete the discussion of Section 5, it needs only to be pointed out that, absent an exemption, Sections 5(a)(1) and (2) prohibit the sale or delivery of a security unless a registration statement is in effect as to such security; that Section 5(b)(1) prohibits the use of any prospectus other than one conforming to Section 10; and that Section 5(b)(2) prohibits the delivery of a security upon a sale unless it is accompanied or preceded by a definitive prospectus conforming to the requirements of Section 10(a) of the Act.
>
> *When read with Section 2(10), Section 5 also requires that a confirmation of sale after effectiveness of registration must be preceded or accompanied by a definitive prospectus;* and that the initial written communication to a prospective purchaser after effectiveness must be the definitive prospectus.
>
> Any other written communication may accompany or follow the definitive prospectus, provided, of course, it does not offend applicable antifraud provisions." (emphasis added)

Similarly, in a well-reasoned decision, Judge Friendly pointed out that the sending of a confirmation neither accompanied nor preceded by a prospectus is a violation of § 5(b)(1) of the Securities Act of 1933, which entitles the purchaser to rescind the transaction. *Diskin* v. *Lomasney & Co.*, 452 F.2d 871 (2d Cir. 1971). Although that decision focused principally on a letter which had been sent to the purchaser prior to the confirmation, the Court ob-

served that the sending of the confirmation without a prospectus "was itself a violation of § 5(b)(1)." 452 F. 2d at 875.

In granting rescission to the purchaser, the Court observed:

> "The result here reached may appear to be harsh, since Diskin had an opportunity to read the final prospectus before he paid for the shares. But the 1954 Congress quite obviously meant to allow rescission or damages in the case of illegal offers as well as of illegal sales. Very likely Congress thought that, when it had done so much to broaden the methods for making legal offers during the "waiting period" between the filing and the taking effect of a registration statement, it should make sure that still other methods were not attempted. Here all Lomasney needed to have done was to accompany the September 17, 1968 letter with any one of the three types of prospectus for the Continental shares mentioned in the extract we have quoted from Professor Loss' treatise. Very likely Congress thought a better time for meaningful prospectus reading was at the time of the offer rather than in the context of confirmation and demand for payment. *In any event, it made altogether clear that an offeror of a security who had failed to follow one of the allowed paths could not achieve absolution simply by returning to the road of virtue before receiving payment.*"
> 452 F.2d at 876 (emphasis added)

Thus, in order to effect a valid sale a seller must comply absolutely with the requirements of the statute; the subsequent delivery by Tobey & Kirk of a prospectus with the securities tendered did not undo the violation which was complete when Tobey & Kirk transmitted to Faulkner a

confirmation of sale neither accompanied nor preceded by a § 10(a) or "white" prospectus.

Plaintiffs seek to avoid the inexorable consequence of Tobey & Kirk's failure to comply with the relevant legal requirements by confecting a series of demonstrably erroneous arguments, each of which is readily disposed of.

First, although a confirmation and a "comparison" contain the same information and some brokers use the same form to confirm transactions with brokers and non-brokers, plaintiffs contended that a confirmation to a broker should be excluded from the definition of a prospectus in § 2(10) of the Securities Act because brokers are required by the N. A. S. D. Rules to confirm transactions with other brokers.

That argument, which "puts the procedural cart before the statutory horse" (Decision; A-12), is demonstrably without merit. Apart from the fact that brokers are required to confirm transactions with non-brokers as well (see § 12 of the N. A. S. D. Rules of Fair Practice), there is no inconsistency between the requirements of the Securities Act and the N. A. S. D. Rules. The violation here consisted of the failure to deliver a prospectus with the confirmation of the transaction. There is no reason why any broker cannot and should not comply with both the Securities Act and the N. A. S. D. Rules. If it sells stock included in a registration statement, it must confirm the sale and deliver a prospectus with or prior to the confirmation. If it does not have a prospectus to deliver, it may not make the sale until a prospectus is obtained.

A second argument is that plaintiffs should not suffer the consequences of Tobey & Kirk's failure to deliver a prospectus, although Tobey & Kirk admittedly acted as plaintiffs' broker and as such, sold the stock to Faulkner (Stipulation, No. 4; A-101). However, as appears below in the discussion of Faulkner's fourth affirmative defense (Point IV, *infra*), because of well-established principles

of the law of agency, plaintiffs must indeed bear the consequences of Tobey & Kirk's violations of law.

Indeed, in *Schillner* v. *H. Vaughan Clarke & Co.*, 134 F. 2d 875 (2d Cir. 1943), a brokerage company sold stock through its agent, who sold the stock in violation of § 12 of the Securities Act of 1933. The evidence was in conflict as to whether the brokerage company was itself principal or was in turn an agent for its principal stockholders. The Court held the brokerage company liable "regardless of whose stock was sold, for the statute applies to a seller whether he acts as principal or broker." 134 F. 2d at 879.

The principal contention made by plaintiffs is equally without merit. Arguing that a confirmation of a sale from a broker to a broker or dealer need not be accompanied by a prospectus, they point out that the definition of the term "prospectus" in § 2(10) was expanded in 1954 to include the words "or confirms [the sale of any security]." They then refer to a 1941 Opinion of the General Counsel for an interpretation of that language (Securities Act Release No. 33-2623 (July 25, 1941), 17 C. F. R. § 231.2623), CCH Fed. Sec. L. Rep. ¶ 3195-99, which illustrates the prospectus delivery requirements in question and answer form. Plaintiffs place heavy reliance on question and answer No. 8 which states that a broker need not send a prospectus to a dealer with securities sold to the dealer, or with the confirmation of sale, because the transaction was exempt as an unsolicited brokerage transaction.

Plaintiffs' argument is plainly frivolous. The 1941 Opinion of the General Counsel in no respect indicates that a confirmation to a broker or dealer is not a prospectus. Indeed, it explicitly states that a confirmation *is* a prospectus, but that a § 10(a) prospectus need not be delivered with a confirmation or with securities *in an exempt transaction,* whether that transaction be between a broker and his customer or a broker and a dealer. Plaintiffs' confusion results from their mistaken belief that the determination

whether a communication is a prospectus depends upon whether the transaction is or is not exempt. On the contrary, the General Counsel illustrated in question and answer form various situations in which transactions were exempt from the requirements of § 5, and hence no prospectus need be delivered with the securities or with the confirmation of sale, or were not exempt, so that a prospectus would be required.

The transaction here was not an exempt transaction. None of the provisions of § 4 of the 1933 Act were applicable. Because Tobey & Kirk was a "dealer" as defined by Section 2(12), 15 U. S. C. § 77b(12)*, and because the transaction occurred within 40 days from the date the registration statement became effective, neither § 4(1), 15 U. S. C. § 77d(1), nor § 4(3), 15 U. S. C. § 77d(3), was applicable. Section 4(2), 15 U. S. C. § 77d(2), was inapplicable on its face. Hence, the only remaining exemption which can be argued to apply is that provided by § 4(4), 15 U. S. C. § 77d(4), the brokers' transactions exemption.

The brokers' transactions exemption must be read in the context of the entire statute. When so read, it is clearly inapplicable to the transaction here. The 1933 Act requires that every offer and sale of a security be made in compliance with § 5 of the Act (assuming the related use of mails or other communication in interstate commerce), unless the security is exempt under § 3 or the transaction is exempt under § 4. The brokers' transactions exemption

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*Notwithstanding the explicit definition of the term "dealer" in § 2(12) to mean "any person who engages for all or any part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person", plaintiffs boldly assert that the sale of plaintiffs' stock by Tobey & Kirk was an exempt transaction under § 4(1), because, they say, "[it] seems quite clear that Tobey & Kirk was neither 'an issuer, underwriter or dealer'." (Pltfs' Brief, p. 25)

—§ 4(4) (previously numbered § 4(2))—reads as follows:

> "brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders."

That statute has no application here, for several reasons.

First, Tobey & Kirk was not merely acting as a broker, but was an "underwriter". See the discussion of Faulkner's third affirmative defense (Point III, *infra*). Thus, plaintiffs have no basis for any reliance on § 4(4).

Second, unlike the John Doe in the Question No. 8 of the General Counsel, who had acquired his warrants in a registered offering by AT&T to its stockholders and sold them through his broker, plaintiffs were themselves distributing stock in a registered offering. Plaintiffs' sales were part of a distribution of securities by White Shield Corporation and various selling stockholders (Solomon affid., ¶ 2; A-120-1), and were therefore subject to the requirements of § 5 of the Securities Act (see the discussion in Point III, *infra*), whether or not their broker was itself an underwriter. Indeed, the prospectus in which plaintiffs were named identified them as putative underwriters (Stipulation, No. 17; A-104). Because plaintiffs' sales were subject to § 5, they have no basis for arguing that they are relieved of the consequences of the failure of Tobey & Kirk to deliver a prospectus merely because their sales were effected through a broker. Securities Act Release No. 131, March 13, 1934, 11 F. R. 10946, CCH Fed. Sec. L. Rep. ¶¶ 2910-11.

Third, the Opinion of the General Counsel referred to was superseded by the adoption in 1951 of Rule 154 under the Securities Act of 1933.* That Rule was amended in

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*See Securities Act Release No. 3421, adopted August 2, 1951, which specifically stated that Rule 154 "supersedes those portions of Securities Act Release No. 2623 (11 F. R. 10964, 10965) designated as questions and answers 8 and 10."

1954* (and subsequently rescinded on April 15, 1972), to make very clear that the term "brokers' transactions" as used in § 4(2) (now § 4(4)) only applies to specified kinds of brokerage transactions where specified conditions are met. One such condition is that:

> "(4) the broker is not aware of circumstances indicating that his principal is an underwriter in respect of the securities *or that the transactions are part of a distribution of securities* on behalf of his principal." (emphasis added)

Tobey & Kirk was admittedly aware that the transactions were part of a distribution (Stipulation, Nos. 1-3; A-100-1). Thus, there is no basis for any claim that the sale to Faulkner was exempt from the requirements of § 5 or that Tobey & Kirk should not have delivered a prospectus to Faulkner with or prior to the confirmation of sale.

For an enlightening discussion of the limitations of the applicability of § 4(4), see *United States* v. *Wolfson,* 405 F. 2d 779 (2d Cir. 1968), *cert. denied,* 394 U. S. 946 (1969), which squarely and unequivocally rejects the proposition that sellers distributing securities, or their brokers who have knowledge of the distribution, may avail themselves of this exemption. Thus, plaintiffs have no basis for any argument that the sale to Faulkner was exempt by reason of § 4(4) or otherwise.

Indeed, this Court concluded in 1941 that an exemption cannot be applied to a component part of an entire transaction where the latter is not exempt. *S.E.C.* v. *Chinese Consolidated Benevolent Association, Inc.,* 120 F. 2d 738 (2d Cir.), *cert. denied,* 314 U. S. 618 (1941). In that case, the Court noted:

> "Even if the defendant is not itself 'an issuer, underwriter, or dealer' it was participating in a transac-

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*See Securities Act Release No. 3525 (December 22, 1954).

> tion with an issuer, to wit, the Chinese Government. The argument on behalf of the defendant incorrectly assumes that Section 4(1) applies to the component parts of the entire transaction we have mentioned and thus exempts defendant unless it is an underwriter for the Chinese Republic. Section 5(a)(1), however, broadly prohibits sales of securities irrespective of the character of the person making them. The exemption is limited to 'transactions' by persons other than 'issuers, underwriters or dealers'. It does not in terms or by fair implication protect those who are engaged in steps necessary to the distribution of security issues. To give Section 4(1) the construction urged by the defendant would afford a ready method of thwarting the policy of the law and evading its provisions." 120 F. 2d at 741

Nor do plaintiffs' arguments that a confirmation of a sale of securities to a broker-dealer is not a "communication . . . which . . . confirms the sale of any security" within meaning of § 2(10), based upon their view of the purposes of the Securities Act, have any merit. Acknowledging that a confirmation to a non-broker purchaser is a prospectus, plaintiffs contend that a confirmation to a purchaser which is registered as a broker-dealer, although literally within the definition of the term prospectus, should not be so construed because it would not serve the intended purpose. On the contrary, a confirmation from one broker to another is a prospectus within the actual meaning and purpose of the definition of that term.

Section 5(b)(1) of the Securities Act of 1933 does not prohibit oral communications to be made pertaining to a sale of securities after a registration statement is filed but before it becomes effective. Written communications are, with limited exceptions, prohibited, unless preceded

or accompanied by a prospectus which complies with the Act. The policy of the statute is to insure that a sale not be made until the purchaser has had an opportunity to read the prospectus containing the disclosures required by the Act.

A written confirmation of a sale, whether to a broker-dealer or any other purchaser, is a document by which a sale of securities becomes legally binding. Under state law, a contract for the sale of securities is not enforceable unless, among other alternatives, it is confirmed by the seller and no objection to its contents is made within 10 days of its receipt. U. C. C. § 8-319. Although, if the purchasing broker-dealer sends a confirmation of the purchase it may also be bound to the contract thereby, that fact does not detract from the function and purpose of the confirmation of sale to it.

Hence, a confirmation of a sale, to a broker-dealer or any other purchaser, may not be sent unless accompanied or preceded by a prospectus. In either case, the confirmation is unequivocally, in the words of the General Counsel in 1941, a "document which is designed . . . to effectuate the disposition of a security" (CCH Fed. Sec. L. Rep. at p. 3129).

By its agreement with plaintiffs, Faulkner purchased more than $600,000 in White Shield stock as a principal for its own account (Stipulation, No. 9; A-102). The fact that Faulkner was a broker-dealer does not diminish its right to receive a prospectus. The Securities Act does not exclude broker-dealers from its protection and in fact, by § 12, permits a right of recovery for violation of § 5 of the Act to the "person" purchasing the security, which by definition (§ 2(2), § 2(12)) includes a broker-dealer.

Indeed, a broker-dealer must deliver the prospectus to its customers who purchase the securities within 40 days after the registration statement becomes effective or the date the securities are first offered to the public. See § 4(3)

of the Securities Act of 1933, 15 U. S. C. § 77d(3). It would be incongruous to subject a broker-dealer to that obligation and at the same time to relieve those distributing the securities in the registered offering from their obligation to deliver a prospectus to the broker-dealer.

Further, the broker-dealer's customers may rely on the broker-dealer in making their investment decisions. Hence, the argument that a prospectus, which contains the disclosures from which the investment decision may be made, need not be sent to the broker-dealer is no less inconsistent with the purpose of the statute than would be an argument that a prospectus need not be sent to any other purchaser.

The decision in *Matter of Collins Securities Corp., supra,* sets forth a test by which it might be determined whether a communication constitutes a prospectus. The test includes an analysis of the statutory purpose and the practical effect of the determination. That analysis requires a determination that a confirmation of sale to a broker-dealer constitutes a prospectus within the meaning of § 2(10). Such an interpretation would be in full accord with the statutory purpose, for the reasons set forth above.

Moreover, the determination that a selling broker's confirmation is a prospectus would not result in practical difficulties, since, as this Court reasoned in *Diskin* v. *Lomasney & Co., supra,* all that the selling broker need do to avoid the consequences of that determination is to accompany the first written communication with a § 10(a) prospectus.

Congress, the S.E.C. and this Court have all concluded that a written confirmation of a sale is a prospectus. It is plainly defined as such in § 2(10) of the 1933 Act. No valid basis has been suggested for a judicially-created amendment of that statute to exclude from its coverage a written confirmation of sale to a broker-dealer.

For the foregoing reasons, it is respectfully submitted that the decision of the District Court granting summary

judgment to Faulkner on its second affirmative defense was correct and should be affirmed.

POINT III

FAULKNER WAS ENTITLED TO SUMMARY JUDGMENT ON ITS THIRD AFFIRMATIVE DEFENSE

Faulkner has asserted as a third affirmative defense that Tobey & Kirk participated in the distribution of the Common Stock of White Shield Corporation being sold by plaintiffs and others and was an underwriter as defined in § 2(11) of the Securities Act of 1933 (15 U.S.C. § 77b(11)); that the prospectus of White Shield Corporation in respect of such distribution did not disclose the participation of Tobey & Kirk as an underwriter, as required by §§ 7 and 10 of the Securities Act of 1933 (15 U.S.C. §§ 77g, j), although Tobey & Kirk had agreed prior to the effective date of the registration statement containing the said prospectus, to participate in the distribution; and that, therefore, the sale to Faulkner was in violation of § 5(b) of the Securities Act of 1933.

Plaintiffs and Faulkner each moved for summary judgment on this defense. The District Court denied both motions on the ground that it could not conclude from the facts to which the parties had agreed whether Tobey & Kirk was an underwriter, and, if so, whether Faulkner had knowledge of that fact.

We are in complete agreement with plaintiffs that the determination whether Tobey & Kirk was an underwriter can be made as a matter of law. As will appear from the agreed facts, Tobey & Kirk was necessarily an underwriter. As will also appear, Faulkner's alleged knowledge of that fact is irrelevant, and the failure to identify Tobey & Kirk as an underwriter in the prospectus delivered to Faulkner on June 15, 1971 gave Faulkner an absolute right to rescind the transaction.

In their appeal from the District Court's denial of their motion for summary judgment, plaintiffs offer four reasons why they say they were entitled to summary judgment on this defense. First, they say Tobey & Kirk was not an underwriter. Second, they say the omission was not material. Third, they say Faulkner could not have been misled by the omission. Fourth, they say the S.E.C. agreed to the post-effective procedure whereby certain dealers would be identified as putative underwriters, so that Faulkner may not assert the omission as a defense. As will be seen, each of these arguments is demonstrably without merit.

A. Tobey & Kirk Was an Underwriter

Plaintiffs contend that Tobey & Kirk was not an underwriter because plaintiffs were not underwriters, but even if they were, since Tobey & Kirk would merely have sold stock for underwriters, it would not thereby have become an underwriter because it effected such sales for standard N. A. S. D. brokerage commissions. Plaintiffs' conclusion is itself based upon conclusions which are squarely contradicted by the facts. This is demonstrated by an analysis which might appropriately commence with the definition of the term "underwriter" in § 2(11) of the Securities Act of 1933, which provides as follows:

> "(11) The term 'underwriter' means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As

> used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer."

Arguing that they were not issuers within the meaning of § 2(11), plaintiffs say (Pltfs' Brief, p. 41) that they purchased their White Shield stock in a private placement some three years before the public offering. By this, plaintiffs are apparently suggesting that they were not underwriters because they did not purchase their stock with a view to its distribution. Therefore, Tobey & Kirk would not be an underwriter in the chain of distribution.

What plaintiffs are suggesting is that had they chosen to, they could have sold their White Shield stock free of federal registration requirements, presumably pursuant to the exemption provided by § 4(1) of the Securities Act as a "transaction by any person other than an issuer, underwriter or dealer." It was plaintiffs' burden to prove this. *Hill York Corp.* v. *American International Franchises, Inc.*, 448 F. 2d 680, 690 (5th Cir. 1971); *Gilligan, Will & Co.* v. *S.E.C.*, 267 F. 2d 461, 466 (2d Cir.), *cert. denied*, 361 U. S. 896 (1959). The evidence must be "explicit, exact, and not built on conclusionary [sic] statements". *Lively* v. *Hirschfeld*, 440 F.2d 631, 633 (10th Cir. 1971). Plaintiffs have adduced no evidence showing that they would have been entitled to sell their stock free of federal registration requirements and indeed have shown precisely the contrary.

Plaintiffs purchased their White Shield stock in September, 1968 from officers and directors of White Shield. Although transfer of the stock was restricted, they also acquired the right to have the stock included in a registration statement to be filed by White Shield (A-163-4). Mr. Ross testified at his deposition that plaintiffs first informed him of the contemplated registered offering several months

prior to June, 1971 (Ross Transcript, pp. 28-31; A-214-7). And Santangelo testified that he imparted this information to Mr. Ross six months prior to June 7, 1971 (Santangelo Transcript, pp. 22-3; A-190-1). Accordingly, it was no later than early 1971 that plaintiffs first arranged to have their stock included in the White Shield offering.

Whether or not plaintiffs could have sold the stock without registration is irrelevant. That is not what occurred. Plaintiffs did in fact participate in the registered offering. Hence, whatever plaintiffs' intentions were at the time of their stock acquisition, they became underwriters by participating in the White Shield distribution.*

If the resolution of Faulkner's third affirmative defense were to depend upon a determination of plaintiffs' subjective intentions at the time they acquired their stock, *i.e.,* whether they acquired it "with a view to . . . distribution", or a determination whether they were themselves issuers, or a determination whether they purchased from an issuer, as defined in § 2(11), summary judgment could not be granted to either party. However, the definition of the term "underwriter" provides alternative bases for the conclusion that they and Tobey & Kirk were underwriters.

The definition of that term includes several categories of persons. These categories are set forth in the disjunctive. It includes any person who

> "has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security,"
>
> or
>
> "participates or has a direct or indirect participation in any such undertaking,"
>
> or
>
> "participates or has a participation in the direct or indirect underwriting of any such undertaking".

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*Plaintiffs were in fact identified as putative underwriters in the prospectus in which they were named (Stipulation, No. 17; A-104).

As will be seen, even if plaintiffs did not purchase their stock with a view to its distribution, both they and Tobey & Kirk became underwriters by virtue of the alternative definitions of that term.

In 1971, White Shield Corporation, which then had 4,735,216 shares outstanding (A-129), had filed four registration statements for the issue of its stock and for the sale by certain stockholders, including plaintiffs, of stock owned by them (A-119-21). One of these registration statements registered 422,513 shares owned by various selling stockholders, including plaintiffs and their associates (Solomon affid. ¶ 2(c); A-121), and became effective June 7, 1971. A second registration statement registered 850,000 shares to be issued by White Shield, and became effective on June 14, 1971 (Solomon affid., ¶ 2(d); A-121). The prospectus included in each of these two registration statements was attached to a prospectus in a third registration statement which registered 472,278 shares owned by two institutional selling stockholders, a post-effective amendment to which became effective June 4, 1971 (Solomon affid., ¶ 2(a); A-120). The fourth registration statement also became effective on June 4, 1971 and registered 559,000 shares, of which 259,000 were outstanding and 300,000 were offered by White Shield Corporation (Solomon affid., ¶ 2(b); A-120).

Plaintiffs and their associates arranged to have their stock included in one of the registration statements, and arranged to have Tobey & Kirk sell the stock for them. Tobey & Kirk, with full knowledge that the stock was being sold in a registered offering, agreed. In so doing, plaintiffs and Tobey & Kirk became participants in the undertaking and the underwriting thereof, and accordingly, became underwriters. See *S.E.C.* v. *North American Research and Development Corp.*, 424 F. 2d 63, 74 (2d Cir. 1970), in which this Court noted that a person who purchased from minority shareholders who were not

issuers nevertheless became an underwriter in selling those shares "in a direct or indirect participation" in a distribution. *Accord, S.E.C.* v. *Culpepper,* 270 F. 2d 241 (2d Cir. 1959), in which this Court concluded that a defendant was an underwriter although he did not purchase his stock directly from a control group nor was he in privity of contract with such group, by reason of the clause in § 2 (11) which includes, within the definition of the term "underwriter", one who "participates or has a direct or indirect participation in any such undertaking." 270 F. 2d at 246.

Hence, whatever plaintiffs' intentions may have been at the time they acquired their stock, in 1971 they elected to participate in a distribution of White Shield stock to be made by White Shield and other selling stockholders. And Tobey & Kirk agreed to act as their distributor, and did so act. It sold the stock, amounting to 144,000 shares, to a group of dealers engaged in the business of selling stock to the public (Stipulation, Nos. 4-7; A-101-2). Tobey & Kirk performed the function of, acted as, and was, an underwriter within the meaning of § 2(11).

Plaintiffs nevertheless contend that Tobey & Kirk did not become an underwriter because, they assert, "the evidence is unequivocal" that Tobey & Kirk received only the standard N. A. S. D. broker's commission for selling plaintiffs' stock (Pltfs' Brief, p. 42).* Contrary to this conclusion, and contrary to the requirements of Fed. R. Civ. P. 56(e), plaintiffs offered no evidence at all on what amount or percentage of the sale price was "usual and customary" for transactions similar to that in issue here, or the amounts paid to other brokers for comparable service in the distribution. However, whatever Tobey & Kirk's

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*Plaintiffs purport to support this unfounded assertion by an Appendix reference (A-232-3) to a conclusory statement by Mr. Ross that a "Normal Stock Exchange Commission" was charged for the sale of White Shield stock to Suez American Corporation, one of Tobey & Kirk's purchasers.

commission may have been, the exception is not applicable to it.

The term "usual and customary distributors' or sellers' commission" is defined in Rule 141(c) of the Commission (S.E.C. Rel. 33-627 (March 15, 1936), CCH Fed. Sec. L. Rep. ¶ 1506) as follows:

> "(c) The term 'usual and customary distributors' or sellers' commission' in Section 2(11) shall mean a commission or remuneration, commonly known as a spread, paid to or received by any person selling securities either for his own account or for the account of others, which is not in excess of the amount usual and customary in the distribution and sale of issues of similar type and size, and not in excess of the amount allowed to other persons, if any, for comparable service in the distribution of the particular issue; *but such term shall not include amounts paid to any person whose function is the management of the distribution of all or a substantial part of the particular issue, or who performs the functions normally performed by an underwriter* or underwriting syndicate." (emphasis added)

See *S.E.C.* v. *North American Research and Development Corp.,* 280 F. Supp. 106, 122 (S. D. N. Y. 1968), *mod on other grounds,* 424 F.2d 63 (2d Cir. 1970).

In selling plaintiffs' White Shield stock, Tobey & Kirk was performing precisely the functions normally performed by an underwriter. Tobey & Kirk was not functioning merely as a broker or dealer intended to be covered by the "usual and customary" commission exception. Tobey & Kirk effected the distribution of $2,000,000 worth of White Shield stock owned by plaintiffs and their associates in three days (Stipulation, Nos. 4-5; A-101). The functions it performed in connection with the distribution were in all respects equivalent to those of a "best efforts" underwriter.

Tobey & Kirk was not, to use plaintiffs' language, merely a "statutory" underwriter, it was a "true" or "contractual" underwriter (Pltfs' Brief, pp. 42-3).

A purchaser of restricted stock who obtains and exercises registration rights, and thereafter sells the stock in a registered offering, runs the risk of having liability imposed upon him as an underwriter. The risk is commensurate with the extent of his participation. See § 11(e) of the Securities Act of 1933, 15 U. S. C. § 77k(e). At the time of his acquisition of his stock, prudence would dictate that he at least obtain the right to verify the information in the prospectus. If the extent of his participation in the distribution is not great, he may elect to rely upon the issuer to comply with the statute, and thereby assume the risk of its noncompliance.

The "usual and customary" commission clause was intended to avoid these consequences to dealers engaged in ordinary retail transactions. Where, however, the dealer performs the functions normally performed by an underwriter, the S.E.C. has determined that it must also assume the responsibilities of an underwriter, and the consequences of the failure to fulfill those responsibilities.

The dealer engaged in ordinary retail transactions would generally not be in a position to attempt to verify information in the prospectus, either directly or through his principals. Nor would his financial interest warrant the imposition of such a responsibility. Where, however, a dealer is actually performing the functions of an underwriter, a different result obtains.

If the dealer's participation in the distribution becomes sufficiently extensive, a fair balancing of the interests of investors against the practicalities of the dealer's involvement justifies the imposition of responsibilities on the dealer to attempt to insure that the requirements of the 1933 Act are fulfilled and its purpose served. Those responsibilities

would include an effort, in order to effectuate the primary purpose of the 1933 Act, to distribute prospectuses to dealers which purchase from the underwriter and which may be expected to resell the securities to the public.

In an offering of outstanding stock by the holders from time to time at prevailing prices, commonly known as a "shelf" or "shelf secondary" offering, it may be difficult to ascertain when a dealer's participation is sufficiently extensive to warrant a determination that the dealer is actually performing the functions normally performed by an underwriter. To facilitate this determination, the S.E.C. has adopted a pragmatic test—a dealer who distributes more than 10% of the offering is deemed to be an underwriter and must be identified in the prospectus by name, as a person who "may be deemed" an underwriter. The quoted language provides the flexibility needed to absolve a dealer from the liabilities attending the underwriter status in appropriate circumstances and which would otherwise result from a strict application of the mathematical test.

Tobey & Kirk did not merely sell more than 10% of the offering made by the two registration statements treated together by the S.E.C. to determine whether a dealer should be identified as an underwriter (A-122). Rather, it acted as a distributor of 144,000 shares which it sold for approximately $2,000,000 (based upon the price to Faulkner) to a group of dealers, many of which were making a market for the White Shield stock.

In the circumstances here, it is submitted that the extent and nature of Tobey & Kirk's participation in the distribution necessarily compels the conclusion that Tobey & Kirk was in fact an underwriter. Although the District Court believed it required further facts to make this determination, it is submitted that the facts here, all of which were submitted or stipulated by plaintiffs, compel the determination as a matter of law.

B. Materiality and Faulkner's Alleged Knowledge

Plaintiffs contend that the omission of the name of Tobey & Kirk from the prospectus was not material. They also contend that Faulkner had knowledge of the facts from which the conclusion that Tobey & Kirk was an underwriter could be made. As to the first point, the very cases cited by plaintiffs (Pltfs' Brief, p. 43), categorically refute this contention. Moreover, in view of Faulkner's status as a market-maker, the fact that Tobey & Kirk was an underwriter was certainly material to it.

In any event, the questions of Faulkner's knowledge and the materiality of the fact not disclosed are not relevant to Faulkner's third affirmative defense. The failure to disclose Tobey & Kirk's status as an underwriter gave rise to rights under § 12(1) of the Securities Act of 1933, 15 U. S. C. § 77l(1). That statute provides for civil liability, and the right to rescind, in the case of an offer or sale of a security in violation of § 5 of the Act. Unlike the rights provided by § 12(2), neither the materiality of the violation nor the knowledge of the purchaser is relevant.

Section 5(b) of the Act, 15 U. S. C. § 77e(b), requires that the prospectus comply with § 10 of the Act, 15 U. S. C. § 77j. The latter section requires that the prospectus contain the information in the registration statement, with certain exceptions. The information required to be included in the registration statement is prescribed by § 7 of the Act, 15 U. S. C. § 77g, which directs generally that the registration statement include the information specified in Schedule A. One such item so specified is "the names and addresses of the underwriters," Schedule A, § 5.

In *S.E.C.* v. *Manor Nursing Centers, Inc.*, 458 F. 2d 1082, 1098-99 (2d Cir. 1972), it was held that the delivery of a prospectus having material omissions violated the prospectus delivery requirements of § 5. The consequence of a violation of § 5 is a right of action under § 12(1),

rather than § 12(2). See Schulz, *Prospectus Must Reflect Developments, etc.*, 71 Mich. L. Rev. 591 (1973).

The District Court concluded that § 12(2) was applicable, rather than § 12(1), because if § 12(1) were applicable, § 12(2) would be meaningless (Decision; A-14-5). The District Court also distinguished *Manor Nursing Centers* on the ground that the discrepancy between the facts presented in the prospectus in that case and the actual facts was so tremendous that a failure to amend the prospectus could be deemed to be a failure to provide a prospectus which conformed to § 10(a) (Decision; A-15).

It is submitted that the analysis of the District Court was incorrect. Section 12(1) provides for absolute liability for a prospectus which does not comply with § 10(a). No showing of materiality is necessary. The question of the purchaser's knowledge is irrelevant. The violation need not even be material. On the other hand, where a prospectus complies on its face with the statute, a right of action under § 12(2) depends upon such factors.

Compliance with the mechanical requirements of the statute is not difficult. To avoid liability under § 12(1), the seller need merely deliver a prospectus containing the prescribed items of information. On the other hand, where the purchaser contends that the information furnished is inaccurate, the elements of proof required by § 12(2) become applicable. The consequences of a violation covered by § 12(1) are more strictly applied than the consequences of a violation covered by § 12(2), not because the former are "grosser", in the words of the District Court (Decision; A-15), but because, compliance with § 12(1) being so much more easily accomplished, violations covered by that provision are less excusable.

Indeed, it may be "grosser" to misrepresent material facts, which would give rise to a right of action under § 12(2), than it would be to fail to timely deliver a § 10(a) prospectus, which would give rise to a right of action under

§ 12(1). However, it is the nature of the violation rather than the degree of culpability which determines which subsection is applicable. By the plain language and meaning of the statute, the failure to deliver a prospectus which meets the requirements of subsection (a) of Section 10 gives rise to a right of action under § 12(1).

Moreover, in determining that an issue existed as to whether Faulkner might have known that Tobey & Kirk was an underwriter, the District Court overlooked the posture of the parties. Faulkner did not commence an action against plaintiffs under § 12, which provides that, in certain circumstances, the purchaser "may sue". It was plaintiffs who commenced the action to recover on the contract. Accordingly, even if Faulkner in fact had knowledge of the fact omitted from the prospectus, plaintiffs would not be entitled to recover.

Tobey & Kirk knew that Faulkner was a market-maker and in fact, selected most of the purchasers of plaintiffs' stock from the "Pink Sheets" (Stipulation, No. 11; A-103). Faulkner agreed to purchase plaintiffs' stock for resale in the ordinary course of its business. The prospectus, which Faulkner would have been required to deliver to its purchasers, failed to comply with the requirements of § 10(a). Accordingly, even if Faulkner had knowledge of that failure prior to its entry into the agreement with plaintiffs, plaintiffs may nevertheless not recover damages. *Kaiser-Frazer Corp.* v. *Otis & Co.*, 195 F. 2d 838, 843-4 (2d Cir.), *cert. denied,* 344 U. S. 856 (1952).

In *Kaiser-Frazer,* this Court denied recovery to an issuer for breach of contract against an underwriter for refusing to perform an underwriting agreement where the prospectus was deficient, notwithstanding the fact that the underwriter knew of the deficiency before entering into the underwriting agreement, on the ground that the contract was against public policy and unenforceable. The Court noted that enforcement of the underwriting contract

according to its terms would result only in a sale to the underwriter, which would not violate the 1933 Act, but concluded that the underwriting contract was so closely related to unlawful acts—the public resale by a deficient prospectus—as to be itself illegal and unenforceable.

The function of a market-maker, like that of the underwriter in *Kaiser-Frazer,* is to purchase securities for resale. The transaction here is not distinguishable from that in *Kaiser-Frazer* in any material respect. Accordingly, plaintiffs may not recover damages whether or not Faulkner had knowledge of the deficiency in the prospectus.*

C. Plaintiffs' Purported Section 19(a) "Defense"

Plaintiffs contend that their failure to identify Tobey & Kirk by name in the prospectus delivered to Faulkner on June 15, 1971 does not provide Faulkner with a defense, because the S.E.C. had agreed to the procedure whereby the prospectus was supplemented subsequent to the effective date to identify by name as putative underwriters N. A. S. D. members selling more than 10% of the stock included in two registration statements. They point to the fact that on June 18, 1971, the White Shield prospectus which included plaintiffs' stock was supplemented to identify Tobey & Kirk as a putative underwriter, and conclude that they were entitled to summary judgment on Faulkner's third affirmative defense by reason of § 19(a) of the Securities Act of 1933, 15 U. S. C. § 77s(a). Plaintiffs' argument is both legally insufficient and unsupported by the facts.

In the first place, the "informal agreement" (Pltfs' Brief, p. 55) of the Staff of the S.E.C. to the procedure by which the registration statement became effective, and

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**A. C. Frost & Co.* v. *Coeur D'Alene Mines Corp.,* 312 U. S. 38 (1941), which was decided 11 years prior to *Kaiser-Frazer,* is not applicable, since as plaintiffs have acknowledged in their discussion of that case (Pltfs' Brief, p. 51), Faulkner has not elected to affirm the contract.

the prospectus subsequently supplemented, does not amount to a "rule or regulation" of the S.E.C. in any respect. While the protective principle of § 19(a) may extend to an act done or omitted in good faith in conformity with an accepted interpretation by the S.E.C. of a rule or regulation (see *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F. 2d 1281 (2d Cir. 1973), which so construed § 23(a) of the Securities Exchange Act of 1934, 15 U. S. C. § 78w (a), a provision similar to § 19(a) of the 1933 Act), it does not confer protection based upon every act done or omitted under the direction of or with the permission of the Staff of the S.E.C. See *Ives* v. *W. T. Grant Company,* 522 F. 2d 749, 756-59 (2d Cir. 1975), which construed a similar provision of the Truth in Lending Act. The "informal agreement" here is not even arguably a rule or regulation of the S.E.C.

Second, the statute has no application where the person invoking it seeks affirmative relief. In asserting Faulkner's third affirmative defense, Faulkner is not seeking to impose any liability upon plaintiffs for "any act done or omitted in good faith in conformity with any rule or regulation of the Commission." Faulkner refused to perform the contract, and it is plaintiffs who would impose liability upon Faulkner for breach of contract. Plaintiffs argue that the posture of the parties is irrelevant and that the policies underlying that protective provision are applicable whether the person invoking its protection is a plaintiff or defendant. On the contrary, the posture of the parties is determinative.

The policies underlying § 19(a) derive from considerations of equity and fairness; it is unfair to impose liability upon a person who acts in good faith in conformity with a rule or regulation of the S. E. C., even if the rule or regulation is subsequently determined to be invalid. Even if the so-called practice involved here were to merit the same considerations as would be applicable to a rule or regulation, it is submitted that other policies come into play where a

violation committed in conformity with a rule or regulation of the S.E.C. is asserted, not as a defense, but in order to overcome one. While it may be unfair to impose liability upon a party for his good faith conformity to an S.E.C. rule or regulation, it is infinitely more unfair to permit that party to obtain affirmative relief from another party who has been injured by the violation.

Moreover, in the latter instance, the use of the courts to obtain such affirmative relief involves other considerations of policy not applicable to the circumstance to which the statute is expressly addressed. Hence, for the very same kinds of policy considerations which impel courts to refuse to enforce illegal contracts, a court may not be used as an instrument to enforce a claim by a violator against the party injured by the violation, even if the violation consisted of an act performed "in conformity with" a rule or regulation. Plaintiffs' reliance on § 19(a) in these circumstances is plainly misplaced.*

Nor do the facts leading to the "informal agreement" by the Staff of the S.E.C. support plaintiffs' attempt to invoke that statute. Although the District Court had concluded that Faulkner raised a significant factual question as to whether all the facts relevant to Tobey & Kirk's status were in fact disclosed to the S.E.C. (Decision; A-15-6), we submit that that question was conclusively answered by affidavits and documents submitted by plaintiffs.

Plaintiffs and their associates, Pedersen and Draddy, owned an aggregate of 148,000 shares which were included

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*Plaintiffs' attempt to invoke § 19(a) in connection with Faulkner's second affirmative defense must fail for the same reasons. No separate discussion thereof is required because § 19(a) is patently inapplicable to Faulkner's second affirmative defense. For the reasons set forth in Point II hereof, plaintiffs' argument based on § 19(a) is squarely refuted by the 1941 Opinion of the General Counsel to which they refer, ignores the case law and the applicable regulations of the S.E.C., and derives from plaintiffs' inability to distinguish two separate and distinct concepts—(1) whether a communication constitutes a prospectus, and (2) whether a transaction is exempt.

in a White Shield registration statement (Stipulation, No. 1; A-100). They had contacted Vincent Ross several months prior to the effective date of the registration statement with a request that Tobey & Kirk sell their stock (Ross Transcript, pp. 28, 30-1; A-214, 216-7). Prior to the date it became effective, they had delivered to him preliminary propectuses which included their stock and that of other stockholders, in an aggregate amount of 422,513 shares (Stipulation, Nos. 2-3; A-100-1).

On May 27, 1971, the Division of Corporation Finance issued its "Letter of Comment" concerning the registration statement covering plaintiffs' stock and another White Shield registration statement. That letter included the following statement:

> "The registrant should undertake to disclose the identity of any NASD members who transact dealings in more than 10% of the shares being registered by these two statements. Any such NASD members should be identified as underwriters *in prospectuses used by the selling shareholders.*" (Solomon affid., ¶ 4; A-122) (emphasis added)

On or about June 3, 1971, George Solomon, the attorney for White Shield Corporation, wrote to plaintiffs and the other selling stockholders to inform them that any broker-dealer participating in the distribution of more than 10% of the shares would be described as an underwriter within the meaning of the Securities Act of 1933, and that he must be promptly notified as to the identity of each such broker-dealer to be used and the number of shares "*which you have requested such broker-dealer to sell on your behalf.*" (A-161 (emphasis added)). This, he explained, was because the same broker-dealer might be used by other selling stockholders. Mr. Solomon informed plaintiffs that the number of shares included in their registration statement was 422,513 and the number of shares included in the other

registration statement referred to in the S.E.C.'s Letter of Comment was 850,000 (A-161).

Plaintiffs knew that they and their associates had requested Tobey & Kirk to sell 148,000 shares, which was in excess of 10% of the total number of shares being sold (Stipulation, Nos. 1-3; A-100-1). And Tobey & Kirk, as a registered broker-dealer, was chargeable with knowledge of the S.E.C. practice of requiring identification as underwriters of dealers who sell more than 10% of the offering. However, neither plaintiffs nor Tobey & Kirk advised Mr. Solomon of those facts; they stood mute.* Accordingly, when the registration statement became effective on June 7, 1971, it did not identify Tobey & Kirk as an underwriter (Stipulation, No. 16; A-103-4).

Plaintiffs first informed Solomon of these facts on June 14, 1971, at which time plaintiff Byrnes wrote to Solomon informing him that plaintiffs and their associates had sold 144,000 shares through Tobey & Kirk (A-123, 162-3). On or about June 18, 1971, plaintiffs' White Shield prospectus was supplemented to identify Tobey & Kirk as a putative underwriter (Solomon affid., ¶ 8; A-224).

Under these circumstances, the facts that White Shield Corporation undertook to amend or supplement the prospectus to identify as underwriters N. A. S. D. members who participated in the sale of more than 10% of the shares offered, and that the S.E.C. permitted the registration statement to become effective, does not amount to an "agreement" on the part of the S.E.C.

The May 27, 1971 Letter of Comment directed that the prospectus used by plaintiffs disclose the identity of puta-

*Faulkner never contended that plaintiffs misrepresented facts to the S.E.C. or had or should have had any direct communications with the S.E.C., a contention which plaintiffs apparently find some need to rebut (Pltfs' Brief, pp. 57-62). Faulkner has simply pointed out that plaintiffs did not inform Mr. Solomon, through whom all communications with the S.E.C. were made (Pltfs' Brief, p. 59), of their arrangements with Tobey & Kirk, although he had specifically requested such information.

tive underwriters. Mr. Solomon requested plaintiffs to advise him promptly of their arrangements with any broker-dealer. Plaintiffs knew that they and their associates had requested Tobey & Kirk to sell a block of securities as a result of which Tobey & Kirk would be required to be identified as an underwriter in prospectuses used by them, but simply ignored Mr. Solomon's request. Hence, the prospectus did not identify Tobey & Kirk, not because of any practice or informal agreement of the S.E.C. Staff, but because plaintiffs simply did not disclose the relevant facts.

The fact that the prospectus used after June 18 contained the required disclosure does not affect Faulkner's third affirmative defense. The prospectus delivered to Faulkner was deficient. Its subsequent correction did not undo the violation. Disclosure must be measured against the facts as they exist at the time. *S.E.C.* v. *Manor Nursing Centers, Inc., supra.* The prospectus delivered to Faulkner was, in the words of the S.E.C.'s Letter of Comment, one of the prospectuses "used by the selling shareholders", and one which did not contain the required disclosure.

Plaintiffs may not invoke § 19(a) for many reasons. It was not intended to apply to the kind of procedure employed by the Staff of the S.E.C. to which plaintiffs would apply it. Nor may it be invoked to obtain affirmative relief. Nor could it under any circumstances apply to the facts here.

Plaintiffs and Faulkner each moved for summary judgment on Faulkner's third affirmative defense and did not dispute any material fact. It is submitted that it was improper for the District Court to deny the motions on the ground that additional facts were required, and that Fed. R. Civ. P. 56 required that summary judgment be granted to Faulkner on the facts presented.

POINT IV

THE DISTRICT COURT ERRED IN GRANTING PLAINTIFFS' MOTION AND IN DENYING FAULKNER'S MOTION FOR SUMMARY JUDGMENT ON FAULKNER'S FOURTH AFFIRMATIVE DEFENSE

By Faulkner's fourth affirmative defense, Faulkner has asserted that plaintiffs and their agent, Tobey & Kirk, in violation of § 10 of the Securities Exchange Act of 1934 (15 U. S. C. § 78j) and Rule 10b-6 thereunder (17 C. F. R. § 240.10b-6), solicited bids from and sold the Common Stock of White Shield Corporation included in the White Shield registration statement to various broker-dealers, including Faulkner, who were at the time market-makers* in the Common Stock of White Shield Corporation; and that, accordingly, the transactions were unlawful, so that plaintiffs are precluded from any right of recovery on their claims against Faulkner. There are no issues of fact with respect to this affirmative defense. Accordingly, it is respectfully submitted that Faulkner is entitled to summary judgment on this defense and that the District Court's dismissal of this defense should be reversed. These same facts are the basis of Faulkner's second counterclaim, which the District Court also dismissed.

In dismissing Faulkner's fourth affirmative defense, the District Court erred in three respects, each of which constitutes a separate and independent ground for reversing

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*The term "market-maker" is defined by S.E.C. Rule 17a-9(f), 17 C. F. R. § 240.17a-9(f), as follows:

> "(f) For purposes of this rule:
>
> (1) The term 'market maker' shall mean a dealer who, with respect to a particular security, holds himself out (by entering indications of interest in purchasing and selling in an inter-dealer quotations system or otherwise) as being willing to buy and sell for his own account on a continuous basis otherwise than on a national securities exchange". See *Chasins* v *Smith Barney & Co.*, 438 F. 2d 1167, 1170 n.4 (2d Cir. 1970).

the District Court in said dismissal. First, the District Court erred in determining that the sale of the White Shield stock to Faulkner and the distribution of which it was a part were not in violation of Rule 10b-6. Second, even if, *arguendo,* it could properly have so determined, the District Court erred because its finding overruled an S.E.C. decision to the contrary which was neither plainly erroneous nor inconsistent with Rule 10b-6. Third, the District Court erred, even if, *arguendo,* it was correct in overruling said decision, because Faulkner was required to cancel its purchase to comply therewith and, accordingly, Faulkner may not be held liable to plaintiffs therefor.

As set forth above in the discussion pertaining to Faulkner's first affirmative defense, there is a dispute as to whether plaintiffs advised Faulkner that the stock being sold to Faulkner was included in a registration statement. However, as will hereinafter appear, the resolution of that issue is irrelevant to the determination with respect to Faulkner's fourth affirmative defense. Whether or not Faulkner was so advised, plaintiffs' participation in the unlawful transactions hereinafter discussed precludes them from any right of recovery against Faulkner herein.

A. Violations of Rule 10b-6 Preclude Plaintiffs From Any Right of Recovery From Faulkner

As appears from the Stipulation, Faulkner entered its name in the "Pink Sheets" for the White Shield stock, and entered bid and asked quotations for the stock in NASDAQ, the automated quotation system of the N. A. S. D., on June 7, 1971 and prior and subsequent thereto (Stipulation, No. 7; A-102). As also appears, Tobey & Kirk sold 144,000 shares of White Shield stock on June 7, 8 and 9, 1971 to 18 broker-dealers, all but three of which were then making a market in the stock, and it selected the purchasers (other than those three) from the "Pink Sheets" (Stipulation,

Nos. 4-7, 11; A-101-3). The sales were therefore made in violation of Rule 10b-6. *Matters of Jaffee & Company, et al.,* 44 S.E.C. 285 (1970), CCH Fed. Sec. L. Rep. [1969-70 Transfer Binder] ¶ 77,805; *Victory Markets, Inc.,* CCH Fed. Sec. L. Rep. [1972-73 Transfer Binder] ¶ 79,115 (1972); *Matter of Collins Securities Corp., et al.,* S.E.C. Release 34-11766 (Oct. 23, 1975), CCH Fed. Sec. L. Rep. [1975-76 Transfer Binder], ¶ 80,327 (1975). And see *Byrnes* v. *Faulkner, Dawkins & Sullivan,* 362 F. Supp. 864, 868 n.3 (S. D. N. Y. 1973).* See also, *Miller* v. *Steinbach,* 268 F. Supp. 255, 280 (S. D. N. Y. 1967).

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*Although plaintiffs had argued to the contrary, Judge Gurfein, who was then a United States District Judge, concluded, in footnote 3 to his June 19, 1973 decision herein, that "*Jaffee* held that it is a violation of Rule 10b-6 under the 1934 Act for a selling broker to sell stock included in a registration statement to a market-maker, or for a market-maker to participate in the distribution, because it would be creating a market price by its own purchases and quotations." (A-29) Plaintiffs were concerned about this conclusion and, by a motion for reargument, requested that the decision be recalled, complaining particularly about that footnote. By an Order dated July 23, 1973, that request was denied (A-32).

It is submitted that plaintiffs' concern about the conclusion reached by Judge Gurfein gave rise to the real reason they have appealed from his Order dismissing their complaint—so that he may not review the ruling of Judge Werker dismissing Faulkner's fourth affirmative defense. Plaintiffs cannot really want a reversal of Judge Gurfein's Order, which would unduly further complicate this action and would only result in the reinstatement herein of their $6,000 claim against Singer, since plaintiffs' claim against Singer is pending in the State Court Action and the rulings herein on Faulkner's affirmative defenses (other than its first) will determine the outcome of that action, because Singer has asserted the same affirmative defenses.

In support of their appeal from Judge Gurfein's June 19, 1973 decision, which in effect held that plaintiffs could not remove the State Court Action to the District Court by seeking a declaratory judgment that defenses asserted in the State Court Action were insufficient, plaintiffs cite *Foremost-McKesson, Inc.* v. *Provident Securities Co.,* —— U. S. ——, 46 L. Ed. 2d 464 (1976) and *Cort* v. *Ash,* 422 U. S. 66, 45 L. Ed. 2d 26, 37 n.11 (1975), which in no way support plaintiffs' position, but merely support the entirely irrelevant proposition that the Declaratory Judgment Act may be employed to determine the validity of a claim threatened under the Securities Exchange Act of 1934. Here, plaintiffs invoked the Declaratory Judgment Act

Rule 10b-6 was promulgated to prevent the maintenance of an artificially high market price during the course of a distribution, which, by suddenly increasing the supply of securities in the market, tends to cause that price to decrease. *Goldstein* v. *Regal Crest, Inc.*, 62 F. R. D. 571, 572-73 (E. D. Pa. 1974). The prohibition of the rule is absolute, so that a violation occurs even where the forbidden bids and purchases do not actually cause the price to rise. *Id.* at n.6.

In *Jaffee,* it was held that a market-maker of a security may not participate in a distribution of that security, and that participation in a distribution by a market-maker violates Rule 10b-6, which provides generally that it shall constitute a "manipulative or deceptive device or contrivance" for certain persons who are participating in a distribution of a security directly or indirectly to bid for or purchase any security of the same class as that being distributed.

In ruling upon Faulkner's fourth affirmative defense, the District Court found that, as Faulkner contended and as plaintiffs did not deny, the offering and sale of White Shield stock of which plaintiffs' stock was a part constituted a distribution* for the purposes of Rule 10b-6 (Decision;

to determine the validity of defenses under federal and state law which had actually been asserted in the State Court Action, and hence sought to remove the controversy from the State Court to the District Court in a circumstance not permitted by Congress or the case law. It is submitted that plaintiffs know that this procedure is not permissible and that the cases which they cited do not support their position, and have appealed from Judge Gurfein's decision for reasons unrelated to its holding.

*A distribution of securities comprises "the entire process by which in the course of a public offering a block of securities is dispersed and ultimately comes to rest in the hands of the investing public." *R. A. Holman & Co.* v. *S.E.C.*, 366 F. 2d 446, 447 (2d Cir. 1966), *cert. denied,* 389 U. S. 991 (1967); *Jaffee, supra,* at p. 83,858 n. 5. For the purposes of Rule 10b-6, "a distribution is to be distinguished from ordinary trading transactions and other normal conduct of a securities business upon the basis of the magnitude of the offering and particularly upon the basis of the selling efforts and selling methods utilized." *Bruns, Nordeman & Co.,*

A-17-8). Thus, as will be seen, for Faulkner to have consummated its agreements would have caused it as a market-maker to participate in a distribution being effected through sales to market-makers in violation of Rule 10b-6.

In *Jaffee,* the selling broker, Lee & Co., had been appointed the exclusive agent for a registered offering of 107,700 or about 28% of the outstanding shares of Solitron Devices, Inc. stock. Over 75,000 of these shares were eventually sold including over 25,000 to Greene & Co., a market-maker in Solitron stock.

The S.E.C. found that Greene & Co. violated Rule 10b-6 with its every purchase of Solitron distribution stock for resale effected while it was making a market in Solitron stock, and that Lee & Co. aided and abetted that violation by selling the Solitron distribution stock to Greene & Co. That determination was made in the absence of any admissible evidence that Greene & Co. had been induced to bid for or purchase the Solitron stock as part of a manipulative scheme. *Jaffee, supra,* at p. 83,858 n. 6. Thus, the S.E.C. found that Greene & Co. became a participant in the distribution and violated Rule 10b-6 merely by reason of its purchase and resale of distribution stock to others while making market bids for and purchases of Solitron stock.

In defending against the charge of aiding and abetting, Lee & Co. argued, *inter alia,* that it had the right to assume that the market-maker to whom it sold was buying the registered stock for investment purposes and thus was not participating in a distribution. The S.E.C. flatly rejected that argument, asserting that Lee & Co. had no basis for assuming that a dealer who was placing orders for the stock in the "Pink Sheets" every day was buying the stock for investment (*Id.* at pp. 83,858-59). *Jaffee* thus held that, as a matter of law, and without regard to the existence of

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40 S.E.C. 652 (1961) CCH Fed. Sec. L. Rep. [1957-61 Transfer Binder] ¶ 76,765. See *Collins, supra,* at pp. 85,799-800. See also Decision of the District Court herein; A-18.

any manipulative intent or purpose, it was illegal for a market-maker to participate in a distribution by purchasing distribution stock from a person on whose behalf the distribution was being made, because it would be, in effect, creating a market price by its own purchases and quotations. This holding, which directly supports Faulkner's fourth affirmative defense, is hereinafter referred to as "*Jaffee's* first holding."

The only way in which a market-maker can legally participate in a distribution is by terminating bidding and purchasing in the open market as provided by Rule 10b-6. *Jaffee, supra,* at p. 83,859. Clause 11 of Rule 10b-6(a)(3) provides that to participate, a market-maker must cease all bids and purchases ten, or, under certain circumstances, five business days before the commencement of the distribution. He can not resume his market-making activity until he has completed selling all of his distribution stock. Rule 10b-6(a)(3) and Rule 10b-6(c)(3)(C). Faulkner, like Greene & Co. in *Jaffee,* was not entitled to such an exemption from the operation of Rule 10b-6. Faulkner had been bidding for and purchasing White Shield stock prior to and during the course of plaintiffs' distribution (Stipulation, Nos. 7, 8; A-102).

The facts here are thus indistinguishable from those in *Jaffee.* Tobey & Kirk, like Lee & Co., was a selling broker of stock included in a "shelf registration", and, like the transactions by Lee & Co., the transactions by Tobey & Kirk were unlawful, even if, as plaintiffs contend, those sales were made without any manipulative intent.

Plaintiffs, as Tobey & Kirk's principals, are thus precluded from any right of recovery on their claims against Faulkner, even if plaintiffs were themselves entirely innocent. *Radiation Dynamics, Inc.* v. *Goldmuntz,* 323 F. Supp. 1097, 1099 (S. D. N. Y. 1971), *aff'd,* 464 F. 2d 876 (2d Cir. 1972) ("A principal may not receive the fruit of the bargain without being charged with a means employed by

his agents in obtaining it"); *People* v. *S. W. Straus & Co.*, 156 Misc. 642, 282 N. Y. S. 972 (Sup. Ct. 1935) (A buyer of bonds defrauded by his seller's agent may rescind even where the fraud was unauthorized or even prohibited by the seller).

Furthermore, although Faulkner contends it had no knowledge of the fact that the stock being sold to it was part of a distribution, any issue of fact as to such knowledge is irrelevant to Faulkner's fourth affirmative defense. The illegality of the transaction precludes plaintiffs from any right of recovery. *Kaiser-Frazer Corp.* v. *Otis & Co.*, 195 F. 2d 838 (2d Cir.), *cert. denied,* 344 U. S. 856 (1952).

In that case, Kaiser-Frazer Corporation entered into a contract for the sale of 900,000 shares of its unissued common stock to Otis & Co. and two other securities underwriters, who in turn were to offer the stock for sale to the public. The contract made the purchasers' obligation to accept the stock subject to certain conditions, including an obligation of Kaiser-Frazer's counsel to deliver an opinion that there were no material legal proceedings pending against the issuer, and a condition that the registration statement covering the shares to be sold was not to contain any untrue statement of material fact. On the day of the closing, Otis refused to accept the stock, assigning as its reason its rejection of the opinion of Kaiser-Frazer's counsel that no material litigation was then pending which would affect the issuance of the stock. It appeared that a suit had been commenced on the morning of the closing date by a Kaiser-Frazer stockholder.

Kaiser-Frazer then brought the action against Otis seeking damages for breach of the underwriting contract. Kaiser-Frazer charged that Otis had inspired the institution of the stockholder's suit and had repudiated the underwriting contract without excuse. Otis asserted as an affirmative defense that the prospectus included in the registration statement contained a misrepresentation concerning

Kaiser-Frazer's profit for the month of December 1947. This Court found that the December 1947 earnings set forth in the prospectus were materially overstated and, accordingly, directed that the District Court enter judgment for Otis.

Kaiser-Frazer argued that since Otis had full knowledge of the facts underlying the final figures set forth in the prospectus, and in fact participated in the preparation of the registration statement and prospectus, it could not rely on such facts as a defense. The Court, acknowledging that there was support in the record for Kaiser-Frazer's assertion that Otis did have full knowledge of all of the facts, nevertheless rejected Kaiser-Frazer's argument, based upon the clear rule that a contract which violates the laws of the United States and contravenes public policy as expressed in those laws is unenforceable.

Kaiser-Frazer argued that the underwriting contract between Kaiser-Frazer and Otis was separate from Otis' intention to resell the stock to the public, which would have violated the Securities Act of 1933 by reason of the deficient prospectus. It was argued that Otis did not necessarily have to resell the stock and could have retained it, and that, therefore, the underwriting contract could have been performed without completing an illegal act. The Court rejected that argument, because it found that the contract was so closely related to the contemplated performance of illegal acts as to be itself illegal.

Turning to the facts here, Tobey & Kirk knew that its purchasers were making a market for the White Shield stock since they were entering quotations for the stock in the "Pink Sheets" every day, and has admitted that it selected its purchasers from the "Pink Sheets" (Stipulation, No. 11; A-103). Thus, the sale to Faulkner and the other broker-dealers was so closely related to the contemplated distribution by Tobey & Kirk's purchasers as to make the entire transaction illegal and unenforceable.

The extent to which Tobey & Kirk, as agent for plaintiffs and others, actually succeeded in effecting an illegal distribution becomes apparent upon a review of the June 7, 1971 prospectus of White Shield Corporation (A-138-41, 125-9), and the affidavit of White Shield's attorney, George Solomon, which was submitted by plaintiffs (A-119-24). That prospectus shows that plaintiffs' stock was part of a shelf secondary offering of 422,513 shares. In addition to that offering, White Shield Corporation, which had 4,735,216 shares outstanding (A-129), had filed three other registration statements with the Securities and Exchange Commission covering an aggregate of approximately 2,150,000 shares.

Because of the *Jaffee* decision, securities dealers making a market in the White Shield stock could not participate in the distribution being made by the June 7, 1971 prospectus or any other prospectus included in the four registration statements. Nor were the sellers permitted to sell the stock through the market-makers. The basis of the *Jaffee* decision was that a market-maker could not so participate because it would be creating the market price of the stock with its own purchases and quotations while at the same time selling the stock to the public.

However, on June 7, 8 and 9, 1971—within two days after the registration statement covering the White Shield shares sold by Tobey & Kirk became effective—Tobey & Kirk, ignoring Rule 10b-6, quickly completed its participation in the distribution by selling 144,000 shares and, of them, 70,900 through market-makers (Stipulation, Nos. 4-6; A-101-2), thus resulting in the public sale at artificial prices not only of those shares but of other shares included in the distribution, and in a consequent loss to the purchasers by reason of the inevitable subsequent price decline (see Stipulation, No. 29; A-107-10). Hence, under the principles enunciated in *Kaiser-Frazer,* plaintiffs' contract claim against Faulkner is unenforceable, because, as Judge

Hand noted, "regardless of the equities as between the parties . . . the very meaning of public policy is the interest of others . . ."195 F. 2d at 844.

B. *Jaffee's* First Holding Was Correct

In dismissing Faulkner's fourth affirmative defense, the District Court found that Faulkner's purchase of 44,000 shares of distribution stock from principals of the distribution for resale in the ordinary course of its business while simultaneously making a market in the stock would not have violated Rule 10b-6, because Faulkner would not have thereby effected a distribution nor would it have "sufficiently participated" in the distribution then being made (Decision; A-20). Thus, the District Court overruled *Jaffee's* first holding that the purchase and sale of distribution stock by a dealer then making a market in the stock from a person on whose behalf the distribution is being made constitutes a *per se* violation of Rule 10b-6.

Acknowledging its rejection of *Jaffee's* first holding, the District Court wrote as follows:

> "The SEC in *Jaffee* seems also to have adopted the reading urged by the defendant:
>
> > 'G Co. [Greene], which engages mainly in trading securities for its own account, purchased as principal through Horn over 25,000 shares of registered Solitron stock from Lee for resale. *With every such purchase of stock and until such shares were resold, G Co.,* which received copies of the Solitron prospectus from Lee and thus was aware that a distribution of registered Solitron stock was in progress, *became a participant in the distribution and subject to the prohibitions in Rule 10b-6. Jaffee, supra* at 83,858.'
>
> Nonetheless, this Court is not inclined to accept so readily this interpretation." Decision; A-19. (emphasis added)

The S.E.C. had made it clear in the language quoted and rejected by the District Court that *every* purchase of distribution stock by a dealer then making a market in the stock constitutes participation in the distribution and a violation of Rule 10b-6. The District Court disagreed on two grounds. First, it found that the S.E.C. had misread or at least misquoted its own Rule 10b-6 (Decision; A-19). Second, it found that the S.E.C. had itself impliedly overruled *Jaffee's* first holding in *Matter of Collins Securities Corp., et al.*, CCH Fed. Sec. L. Rep. [1975-76 Transfer Binder], ¶ 80,327 (1975), and had there determined that the purchase of distribution stock by a market-maker in the ordinary course of its business and without manipulative intent does not constitute participation in the distribution. It is submitted that the District Court erred, that *Jaffee* was correctly decided and that *Collins,* which the District Court misread, affirms *Jaffee's* first holding.

The District Court determined that, in *Jaffee,* the S.E.C. misread or misquoted its official text of Rule 10b-6, 20 Fed. Reg. 5075 (1955) (Decision; A-19). In consequence, the S.E.C. determined that Rule 10b-6 prohibited bids and purchases of a stock by a "person who . . . is participating in a particular distribution directly or indirectly", *Jaffee, supra* at p. 83,858 n.5., whereas, in the view of the District Court, the official text of the Rule simply prohibits a person "participating" in a distribution of a stock from directly or indirectly bidding for or purchasing it (Decision; A-19). On that basis, the District Court refused to defer to *Jaffee's* first holding, stating:

> "This court does not accept therefore the defendant's contention that it ought to defer to this agency's interpretation since that interpretation is based at least in part on a misreading of the statute." Decision; A-19.

Thus disencumbered of the S.E.C.'s reading of its own Rule, the District Court substituted its own: a market-

maker was subject to Rule 10b-6 only if he was "sufficiently" participating in a distribution (Decision; A-20).

The District Court determined that Faulkner's purchase from plaintiffs would have amounted to about 3.5% of the aggregate number of shares included in the White Shield registration statements, which the S.E.C. had, for the purpose of the Securities Act of 1933, regarded as a single offering or distribution of White Shield stock.* The District Court further found that Faulkner's purchase would have amounted to 1.4% of the total amount of White Shield stock registered by all of the White Shield registration statements in June, 1971. It appears that the District Court determined that Faulkner could not thereby have "sufficiently" participated in the distribution, so as to be subject to Rule 10b-6, unless that purchase was of sufficient magnitude so that the resale of the shares included therein would, when viewed in isolation, have constituted an independent distribution under Rule 10b-6. In fact, the District Court characterized the question of whether Faulkner would have been a participant in plaintiffs' distribution as but "a slightly different formulation of the question" whether Faulkner's purchase would in itself have constituted a distribution (Decision; A-20 n. 27).

The District Court erroneously relied upon *Bruns, Nordeman & Co.,* 40 S.E.C. 652 (1961), CCH Fed. Sec. L. Rep. [1957-61 Transfer Binder] ¶ 76,765, in finding that Faulkner would not have been a participant in the distribution, stating as follows: "Under the *Bruns, Norde-*

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*The District Court's observation (Decision; A-20) that the S.E.C. evidently treated all the shares sold under two registration statements as one offering was apparently predicated upon the Letter of Comment from the S.E.C. referred to in the Solomon affidavit (A-122). However, the S.E.C. treated the two registration statements as comprising one distribution for the purpose of determining whether the participation of any broker-dealer made it an underwriter as defined by § 2(11) of the 1933 Act, and not for the purpose of determining whether it was participating therein within the meaning of Rule 10b-6.

man standard, Faulkner has not made a distribution of White Shield stock nor has it sufficiently participated in a distribution pursuant to *Collins*." On its face, the passage from *Bruns, Nordeman,* quoted and evidently relied upon by the District Court (Decision; A-18, 20), merely considers and further defines the concept of "distribution", but not the concept of participation in a distribution.

Similarly, as will hereinafter be seen, *Collins* does not even purport to make any general statement on what constitutes "sufficient" participation in a distribution. The District Court's reference to *Collins* in the quoted excerpt from its Decision is significant, however, in that *Collins* cites and paraphrases the passage from *Bruns, Nordeman* on which the District Court relies, holding it to be the general test of what constitutes a distribution under Rule 10b-6.

Pursuant to the authority conferred by Section 10(b) of the Securities Exchange Act of 1934, the S.E.C. has promulgated an elaborate regulatory scheme to prevent the creation of artificial market conditions. Rule 10b-6 is part of that scheme, and is designed to prevent the creation of a market price by those interested in a distribution. Broker-dealers making a market in a stock have the power to create the price by their own quotations in the "Pink Sheets" and NASDAQ. Unlike the case of White Shield, markets are made in many stocks traded over-the-counter by only one or two dealers. The market-makers are the market and their quotations in large part determine the market price. Thus, Rule 10b-6 prohibits their participation in a distribution while they are, in effect, creating the market price by their own market-making activity.

Thus, in *Goldstein* v. *Regal Crest, Inc.*, 62 F. R. D. 571 (E. D. Pa. 1974), the Court stated the purpose and context of Rule 10b-6 as follows:

> "Rule 10b-6 is one of three SEC rules governing the activities of persons interested in a distribution

> of securities and of rights to purchase securities. [Rules 10b-6, 10b-7 and 10b-8 (17 C. F. R. §§ 240. 10b-6, 240.10b-7, 240.10b-8)] The rules represent a careful balance between the interests of the investing public in being free from manipulative devices which tend to artificially affect the price at which a security is being offered and the interests of corporate financiers whose distribution of securities, by a sudden increase in the supply of securities in the market, tends to cause a decrease in the price of the security being offered not reflective of the true market value. Efforts made by persons interested in a distribution to prevent a decline in the open market price of the security being distributed are referred to as stabilizing activities. These stabilizing activities generally consist of the bidding for or the purchase of the securities being distributed by persons involved in the distribution for the purpose of 'pegging' or 'fixing' the price of the security. Stabilizing activities not performed in accordance with Rules 10b-6, 10b-7 and 10b-8 constitute an unlawful manipulative device violative of §§ 9(a)(6) (when performed on an exchange) and 10(b) of the Securities Exchange Act of 1934, 15 U. S. C. §§ 78i(a)(6) and 78j(b)." *Id.* at 573-74 (footnotes omitted).

In sanctioning the methods employed by plaintiffs' broker, Tobey & Kirk, the District Court undercut the S.E.C.'s regulatory scheme designed to strictly limit and control stabilizing.

Tobey & Kirk effected a distribution of a block of 144,000 shares of stock—a distribution of approximately $2,000,000 in White Shield stock—which was part of a massive distribution, to 18 broker-dealers, including Faulkner, of whom 15 were regularly entering bids for and pur-

chasing and selling the stock and thus creating the market price by their market-making activity. In determining that the sale to Faulkner would not have "sufficiently" made Faulkner a participant in that distribution to bring it under Rule 10b-6, the District Court erroneously isolated the number of shares sold to Faulkner and ignored the context in which it occurred.

Using the analysis adopted by the District Court, Tobey & Kirk could have distributed the entire offering on behalf of plaintiffs and the other stockholders on whose behalf the distribution was being made through a large number of brokers and dealers, or underwriters, who could have simultaneously entered bids for the stock, and, if none of them purchased a significant percentage of the offering, there would have been no violation. And even if, as in the instant case, only some of the shares were distributed through market-makers, the effects on the market would have been pronounced, causing not only those shares, but all of the shares in distribution, to sell at an artificially high price. Hence, the District Court's sufficiency of participation test condones a procedure which results in the very conditions Rule 10b-6 was designed to prevent—an artificially maintained market during the course of a distribution.

In arriving at the sufficiency of participation test, the District Court misconstrued *Collins, supra. Collins* does not support that test. To the contrary, *Collins* supports *Jaffee's* first holding—that a purchase of distribution stock by a dealer making a market in the stock constitutes a *per se* violation of Rule 10b-6.

Collins was a decision involving a broker-dealer, which, at the behest of the principals in a distribution, undertook to bid for and purchase the security to be distributed for the specific purpose of effecting a rise in the market price thereof. Thus, in *Collins,* the broker-dealer engaged in market-making with manipulative intent, and there was no occasion to consider the validity of *Jaffee's per se* pro-

hibition of purchases of distribution stock by market-makers.

In *Collins,* however, the S.E.C. reconsidered and expressly overruled a second holding of *Jaffee* ("*Jaffee's* second holding"), that any registered offering of securities under the Securities Act of 1933 is *ipso facto* a distribution for the purposes of Rule 10b-6.*

In *Collins,* as in the instant case, a Rule 10b-6 distribution existed independent of the fact of a registration under the Securities Act of 1933. Thus, in *Collins,* there was no need for the S.E.C. to reconsider either *Jaffee's* first or second holdings. Nevertheless, the S.E.C. did reconsider *Jaffee* and expressly modified it by overruling only its second holding, tacitly affirming its first holding.

In *Collins,* the S.E.C. began its reconsideration of *Jaffee's* second holding with a comparison of the differing policies of the Securities Act of 1933 and Rule 10b-6. The S.E.C. observed that under certain circumstances, the public dissemination of as few as 200 shares of an actively traded stock might require registration under the Securities Act of 1933, and concluded that no purpose would be served by regarding such a registered offering as a distribution under Rule 10b-6, since it would not be of such a nature and magnitude as to tempt a participant therein to engage in manipulative bids or purchases.

That *Collins* overruled only *Jaffee's* second holding, but impliedly reaffirmed its first, appears from the following passage from that decision:

**Collins* was decided while the motions for summary judgment in the District Court were *sub judice*. Shortly before *Collins* was decided, Judge Pierce of the United States District Court for the Southern District of New York evidently concluded that *Jaffee's* second holding was correct. Judge Pierce wrote: "A public offering of stock pursuant to a registration statement would clearly constitute a distribution within the meaning of Rule 10b-6." *S.E.C.* v. *Rega,* CCH Fed. Sec. L. Rep. [1975-76 Transfer Binder] ¶ 95,222 at p. 98,145 (S. D. N. Y. 1975).

"The purpose of the Securities Act is to provide adequate disclosure about an issuer through the registration process in situations where registration is necessary and practicable. The Securities Act contemplates that registration will be required, absent some special exemption, when securities are publicly offered by or on behalf of an issuer or are purchased from an issuer for public resale, and the term "distribution" as used in the Act has been interpreted to accomplish that purpose. Thus, as Commissioner Smith pointed out, if an individual acquires 200 shares of an actively traded stock from the issuer and promptly sells them on an exchange, it is clear that registration would be required.

Rule 10b-6, on the other hand, is designed to prevent manipulation in the markets. To that end, it precludes a person from buying stock in the market when he is at the same time participating in an offering of securities which is of such a nature as to give rise to a temptation on the part of that person to purchase for manipulative purposes. The term distribution in Rule 10b-6 should therefore be interpreted to identify situations where that temptation may be present. Our opinion in *Bruns, Nordeman* attempted to define distribution so as to identify such circumstances.

If the term distribution in Rule 10b-6 were to be equated with the concept of public offering or distribution in the Securities Act, this would not only extend the restrictions of Rule 10b-6 beyond their intended purpose but could result in unnecessary disruption of the trading markets, particularly where an exchange specialist or other market maker acquires registered stock in the performance of his normal functions. It would obviously make no sense

to conclude that a specialist, who happens to acquire some registered stock in the course of his normal activities, has to get out of the market until after he has disposed of that stock. No one has ever thought that such a result was required, even though specialists might well purchase registered stock being sold under a so-called 'shelf registration.'

We accordingly decline to hold that any offering of securities pursuant to a registration statement automatically constitutes a distribution within the meaning of Rule 10b-6, and the *Jaffee* decision, insofar as it is to the contrary, is overruled [footnote omitted]." C C H Fed. Sec. L. Rep. [1975-76 Transfer Binder] ¶80,327, at p. 85,800.* (emphasis added)

If the S.E.C. had wished to overrule *Jaffee's* first holding in *Collins,* which it did not, it had no less opportunity there to do so than it did to overrule *Jaffee's* second holding, which it did. However, in standing fast upon *Jaffee's* first holding and overruling only its second, the S.E.C. determined that any disruption in the trading markets in the course of an actual Rule 10b-6 distribution and resulting from compliance by the market-makers with *Jaffee's* first holding was necessary to prevent an artificial market.

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*Although the *per se* application of *Jaffee's* second holding was overruled, the S.E.C. noted that the fact that an offering was registered is not irrelevant for the purpose of determining the applicability of Rule 10b-6, and that Rule 10b-6 "undoubtedly applies to most registered offerings", including the offering in *Collins. Id.* Indeed, the S.E.C. noted that the purchase and sale by *Collins* of 73,460 shares of Big Horn stock at a price of 5⅛, or approximately $360,000, was, in view of the market and the sales effort "unquestionably a distribution for the purposes of Rule 10b-6." *Id.* at pp. 85,800-01. It is submitted that Tobey & Kirk's sale of 144,000 shares on June 7, 8 and 9, 1971 to 18 dealers, including 15 market-makers, for approximately $2,000,000, in the context of four registered offerings of large blocks of White Shield stock, was no less "unquestionably a distribution" within the meaning of Rule 10b-6.

Recognizing that, on its face, *Collins* did no more than to overrule *Jaffee's* second holding, the District Court wrote as follows:

> "Thus, in *Collins,* the SEC suggests that were an exchange specialist or a market maker to acquire registered stock in the performance of its normal functions, it would be an unwarranted extension of Rule 10b-6 and would cause an unnecessary disruption of market activities to find that acquisition to be violative of Rule 10b-6, thus requiring the specialist or market maker to get out of the market until he had disposed of the registered shares. *In this court's opinion, this conclusion rests not on a finding that the original sale of the registered shares was not a distribution for the purposes of Rule 10b-6, but rather on the conclusion that the activities of the market maker or specialist did not constitute participation in that distribution.*" (Decision; A-20) (emphasis added)

However, in reaching that conclusion, the District Court misunderstood the fact that the S.E.C. was referring to a registered offering which would *not* constitute a Rule 10b-6 distribution. Only in that limited circumstance had the S.E.C. determined that any market disruption was unnecessary for the protection of the trading market, and except in that limited circumstance, the S.E.C. had determined that the cost of such disruption was justified by the dangers of an artificial market during a true Rule 10b-6 distribution.

The District Court justified its departure from the S.E.C.'s explanation of its *Collins* decision by observing that in *Collins* the "discussion of the activities of Collins and his company and its determination that in fact Rule 10b-6 had been violated focuses primarily on the nature and extent of its own particular role rather than the nature

of the offering in general." (Decision; A-19-20). However, that focus was necessary not only for determining whether a violation had occurred, but to determine which sanctions were to be imposed, a question which *Collins* treats at considerable length. Moreover, the full extent of the market-maker's violation of Rule 10b-6 could not be apprehended without some detailed discussion of its conduct. As far as can be told from the *Collins* decision, the market-maker had never directly purchased distribution stock from any principals of the distribution on whose behalf that distribution was being conducted.

In any event, the fact that the S.E.C. chose in *Collins* to discuss the market-maker's conduct in detail provided no valid basis for the District Court to overrule *Jaffee's* first holding, particularly since the S.E.C. had expressly limited its modification of *Jaffee* to a rejection of its second holding.

In short, the District Court's rejection of *Jaffee's* first holding is entirely unsupportable. It unjustifiably impairs the S.E.C.'s regulatory scheme to limit and control stabilizing and the existence of artificial market conditions, and it is based upon a misapprehension both of the purposes of Rule 10b-6 and of the controlling S.E.C. decisions. It also ignores the relevant facts, in focusing solely on the number of shares sold to Faulkner, without regard to the context in which the sale was made—an unlawful distribution of a large block of shares through a number of market-makers, which was itself a part of a massive distribution of White Shield stock. It is respectfully submitted that for the foregoing reasons the dismissal of Faulkner's fourth affirmative defense should be reversed and that summary judgment should be granted to Faulkner.

C. The District Court Failed to Employ the Proper Standards in Overruling *Jaffee's* First Holding

The District Court expressly refused to defer to the S.E.C.'s interpretation in *Jaffee* of its own Rule 10b-6

because it found that that interpretation was predicated upon a misreading or misquoting of that Rule (Decision; A-19). In so doing, the District Court misapprehended the proper standards for judicial review of the S.E.C.'s interpretations of its own regulations.

The standard for judicial review of an agency's interpretation of its own rule or regulation was set forth by the Supreme Court in *Udall* v. *Tallman,* 380 U. S. 1, 16-17 (1965). In that case, the Supreme Court wrote:

> "When faced with a problem of statutory construction, this Court shows great deference to the interpretation given the statute by the officers or agency charged with its administration. 'To sustain the Commission's application of this statutory term, we need not find that its construction is the only reasonable one, or even that it is the result we would have reached had the question arisen in the first instance in judicial proceedings.' [Citations omitted]
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> * * *
>
> *'When the construction of an administrative regulation rather than a statute is in issue, deference is even more clearly in order.*
>
> Since this involves an interpretation of an administrative regulation a court must necessarily look to the administrative construction of the regulation if the meaning of the words used is in doubt. . . . [*T*]*he ultimate criterion is the administrative interpretation, which becomes of controlling weight unless it is plainly erroneous or inconsistent with the regulation.'*
>
> Bowles v. Seminole Rock Co. 325 U. S. 410, 413-414, 89 L ed 1700, 1702, 65 S Ct. 1205." (emphasis added)

As has been seen, the S.E.C.'s "misreading" of Rule 10b-6, could not have affected the result in *Jaffee,* nor, for

that matter, here. The result reached in *Jaffee* would have been precisely the same whether the words "directly or indirectly" are read to modify the words "is participating" or the words "bid for or purchase". Accordingly, the S.E.C.'s supposed misreading of its own Rule, if it was a misreading, was not a valid basis for refusing to defer to the S.E.C.'s interpretation of Rule 10b-6. On the contrary, a court must adhere to an administrative agency's interpretation of its own rule unless it is clearly unnatural or unreasonable. *Perine* v. *William Norton & Co.,* 509 F. 2d 114 (2d Cir. 1974).

In *Perine,* the question before this Court was whether to confine itself to the literal language of Rule 16b-2(a)(3) (17 C. F. R. § 240.16b-2(a)(3)), promulgated under the Securities Exchange Act of 1934. 509 F. 2d at 119. The S.E.C. filed an *amicus* brief which offered the first authoritative word from the S.E.C. on its interpretation of that clause. This Court (per Mansfield, J.) stated that but for such interpretation, it might have followed the plain meaning of the Rule, which would have been dictated by its language. 509 F. 2d at 120. However, this Court held that it must adhere to the S.E.C.'s interpretation of the clause as stated in its *amicus* brief, writing as follows:

> "The interpretation of a regulation or statute by a regulatory agency that is charged with administering it is given considerable deference by federal courts, [citations omitted], so long as it is not clearly unnatural or unreasonable. Such deference is usually justified on the basis of the agency's superior expertise in the area of its authority. [citation omitted]. In this case we are persuaded that the Commission's interpretation of its regulation and of the 1952 amendments thereto, although informal, should be given considerable weight. The S.E.C. is charged with supervising the enforcement and application

of the nation's federal securities laws, e.g., 15 U. S. C. §§ 77s, 78u and 78w, and is thus uniquely suited to determine what interpretation of its rule best effectuates the purposes of § 16(b) and of the other securities statutes." 509 F. 2d at 120

Perine illustrates how far the District Court here strayed from the proper standard of review in substituting its own for the S.E.C.'s interpretation of Rule 10b-6. In *Perine,* this Court deferred to an informal S.E.C. interpretation first promulgated in an *amicus* brief submitted in that case. By that interpretation the meaning of a Rule was markedly changed.

Here, in contrast, the District Court refused to defer to a formal S.E.C. interpretation, promulgated before the transactions in suit occurred and on which Faulkner and others had rightfully relied, because such interpretation contained, and, in the District Court's view, was based at least in part upon, a grammatical interpretation considered erroneous by the District Court.

In refusing to accord *Jaffee* the required deference because of that immaterial question of grammar, the District Court clearly failed to apply the proper standards of review. *Jaffee's* first holding was not, and was not found to be, "inconsistent with" Rule 10b-6, or clearly or plainly "unnatural", "erroneous" or "unreasonable". See *Udall* v. *Tallman, supra; Perine, supra.* On the contrary, the S.E.C. reasonably and properly determined that the prophylactic purposes of Rule 10b-6 were best served by its *per se* application to every purchase of distribution stock by a market-maker, and in fact could have specifically so provided by rule or regulation. It is respectfully submitted that the District Court misconstrued the scope of the S.E.C.'s power to develop and refine the law through adjudicatory decisions such as *Jaffee. N. L. R. B.* v. *Bell Aerospace Co.,* 416 U. S. 267 (1974).

In *Bell Aerospace Co., supra,* the Supreme Court quoted and reaffirmed its decision in *S.E.C.* v. *Chenery,* 332 U. S. 194 (1947). *Bell Aerospace Co.* emphasized that portion of the *Chenery* opinion which made it clear that administrative agencies are to be accorded great flexibility in developing the law by adjudicatory interpretation. In this regard, the Supreme Court in *Bell Aerospace Co.,* quoting its prior decision in *Chenery,* wrote as follows:

> " 'The function of filling in the interstices of the [Securities] Act should be performed, as much as possible, through this quasi-legislative promulgation of rules to be applied in the future. But any rigid requirement to that effect would make the administrative process inflexible and incapable of dealing with many of the specialized problems which arise . . . Not every principle essential to the effective administration of a statute can or should be cast immediately into the mold of a general rule. Some principles must await their own development, while others must be adjusted to meet particular, unforeseeable situations. *In performing its important functions in these respects, therefore, an administrative agency must be equipped to act either by general rule or individual order. To insist upon one form of action to the exclusion of another is to exalt form over necessity.*' " 416 U. S. at 292-93 (emphasis supplied by the Court).

The concepts of "distribution" and "participation" in a distribution as employed in Rule 10b-6 are concepts which the S.E.C. has determined, in the words of *Chenery,* "must be adjusted to meet particular, unforeseeable situations." The District Court's disregard of *Jaffee* on grammatical grounds was truly a decision "to exalt form over necessity". It is respectfully submitted that *Jaffee's* first holding was neither inconsistent with Rule 10b-6 nor clearly erroneous,

unnatural or unreasonable, and that accordingly, the District Court's dismissal of Faulkner's fourth affirmative defense was erroneous and should be reversed.

D. Civil Liability May Not Be Imposed For Faulkner's Compliance With the Law, as it was Then Interpreted

Although Faulkner contends both that *Jaffee* was correctly decided and that, at the very least, it must be sustained as neither plainly erroneous nor inconsistent with Rule 10b-6 or the Securities Exchange Act of 1934, for the purposes of the ensuing discussion it will be assumed, *arguendo,* that the District Court was correct in overruling that portion of *Jaffee* upon which Faulkner's fourth affirmative defense, as presented in the preceding pages, rests. As will hereinafter appear, even if *Jaffee* was erroneously decided, Faulkner may not be held liable to plaintiffs for repudiating the contract.

At the time of Faulkner's purchase, *Jaffee* was the S.E.C.'s only word upon a question on which no court had yet spoken—the *per se* illegality of a market-maker's purchase of distribution stock. As a result of that decision, Faulkner had two alternatives when delivery of plaintiffs' stock was tendered: it could repudiate its purchase and resale contracts and face lengthy and expensive litigation; or it could consummate its contracts in violation of the law as then interpreted and risk, upon discovery, administrative sanctions, the institution of civil litigation by the S.E.C. and even criminal prosecution.

The kind of dilemma faced by Faulkner was, in part, anticipated by and provided for by Congress in § 23(a) of the 1934 Act, 15 U. S. C. § 78w(a), and § 19(a) of the 1933 Act, 15 U. S. C. § 77s(a). Those sections establish a defense to any liability sought to be imposed under said Acts for any act done or omitted in good faith in con-

formity with any S.E.C. rule or regulation.* The purpose of such a statutory provision is clear: the protection of those who must conform their acts to S.E.C. rules and regulations, and particularly those who, like Faulkner, a registered broker-dealer, operate under, and may only exist and do business by virtue of, a license at all times subject to suspension or revocation by the S.E.C. *Van Aalten* v. *Hurley,* 176 F. Supp. 851 (S. D. N. Y. 1959). In *Van Aalten,* the Court, speaking of Section 23(a) of the 1934 Act, said:

> "Exculpatory provisions of like purport are common in administrative statutes; they appear in the rule-making provisions of all the SEC legislation. Loss, Securities Regulation pp. 1097-1098 (1951). Their purpose is to broadly protect those who understandably[8] rely upon a duly promulgated rule of an administrative agency, notwithstanding that such rule is thereafter invalidated. Such protection takes on increasing importance in this modern era when administrative bodies regulate so substantial a segment of our society, and is especially applicable to those cases where judges themselves entertain diverse views as to validity of a particular rule. [footnote omitted]
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> * * *
>
> [8]"It is common experience that men conform their conduct to regulations by governmental authority so as to avoid the unpleasant legal consequences

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*Even without regard to § 23(a), but for the same considerations of policy and equity embodied in that statute, the Court has inherent power to give prospective effect only to a decision overruling *Jaffee.* Indeed, where there has been reliance upon a rule or regulation subsequently determined to be invalid, it is submitted that justice requires that such a decision be given prospective effect only. *Lemon* v. *Kurtzman,* 411 U. S. 192, 203-209 (1973) (prospective effect given to decision declaring previously untested statute unconstitutional, where contracts had been entered into in reliance thereon).

which failure to conform entails.' Columbia Broadcasting System, Inc. v. United States, 1942, 316 U. S. 407, 418, 62 S. Ct. 1194, 1201, 86 L. Ed. 1563." 176 F. Supp. at 855

This Court, acknowledging that the policies served by § 23(a) could require the application of its principle to establish a defense predicated upon reliance on an S.E.C. interpretation as well as a rule or regulation, extended its literal scope to afford such a defense. *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F. 2d 1281 (2d Cir. 1973).

It is clear that § 23(a) of the Securities Exchange Act of 1934 and § 19(a) of the Securities Act of 1933 do not literally apply to protect Faulkner here, since the only liability asserted against it is not under said Acts but under the state law of contracts. The District Court (Decision; A-20), relying on the literal inapplicability of § 23(a) to any liability not arising under the Securities Exchange Act of 1934, rejected Faulkner's argument that its reliance upon *Jaffee,* whether correctly or incorrectly decided, afforded a complete defense. The District Court apparently construed Faulkner's position as a request for the indiscriminate extension of § 23(a) to preclude liability in a private civil action under state law wherever it would preclude liability under the Securities Exchange Act of 1934. To the contrary, as will be seen, the principle upon which Faulkner relies exists independently of the aforementioned statutory sections, which were cited only by analogy.

Faulkner does *not* contend that an act or omission in adherence with an erroneous S.E.C. determination can never provide the basis for a civil liability under state law. Faulkner does, however, contend that it may not be held civilly liable where the act or omission is required in order to comply with a rule, or administrative interpretation thereof, backed by civil or penal sanctions for the violation

thereof. Where an administrative determination *requires,* rather than *permits,* an act or omission, liability may not be imposed in a civil action for acting in compliance with the determination.

The limited protective principle which relieves Faulkner of any liability here was invoked and applied by the United States Supreme Court in *La Bourgogne,* 210 U. S. 95 (1908). In that case, the owners of a ship which had sunk with great loss of life and property brought a statutory proceeding to limit their civil liability to the various claimants who had commenced actions against them at law and admiralty in various state and Federal courts. Opposing the requested limitation of liability, the claimants contended that the shipwreck and resulting damage were caused by negligence within the privity and knowledge of the owners.

Among the allegations of negligence was that the ship had had insufficient safety apparatus, in violation of a statute requiring such lifeboats and other gear as would best secure the safety of all persons on board in the event of disaster. The owners responded to the allegations of negligence by asserting compliance with requirements fixed for the ship by a board of supervising inspectors pursuant to their rules and regulations. The board had been charged by law with the administration of the statute, and for violation of their rules and regulations a $1,000 fine could be imposed. The claimants countered that such compliance could not avail the owners, since the regulations did not adequately provide for the safety of the passengers and thus were inconsistent with the statute.

The opinion of the District Court reveals that one of the supervising inspectors had testified not only that the ship's complement of lifeboats was adequate and in conformity with the regulations as they had been applied to the ship, but that additional lifeboats would have interfered with its management and would have created more danger than they would have averted. *La Bourgogne,* 117

F. 261, 267 (S. D. N. Y. 1902). Accordingly, the use of additional lifeboats would have amounted to a violation of the regulations and subjected the owners to penalties.

Hence, in *La Bourgogne,* as in the instant case, the claimants sought to impose civil liability in private damage actions against the owners, who had acted in compliance with a mandatory administrative determination backed by sanctions. In such circumstances, the Supreme Court held that it mattered not whether such a determination was erroneous or inconsistent with the statute pursuant to which it was promulgated. No civil liability could thereby ensue. In this regard, the Supreme Court wrote:

> "Again, the contention that the regulations of the board are inconsistent with the statute, we think, when the statute is considered as a whole, is without merit. *Even, however, if it were otherwise, as compliance on the part of the petitioner with the regulations adopted by the board was comp[illegible]d by law, it cannot be that upon it was cast the duty of disobeying the regulation at its peril, thus, on the one hand, subjecting it in case of non-compliance to the infliction of penalties, and, on the other hand, if it fully complied with the regulations, imposing a liability upon the assumed theory that there had been a violation of law.*" 210 U. S. at 134 (emphasis added)

The principle of *La Bourgogne* is no less applicable here. Faulkner had been acting as a market-maker and regularly entered bid and ask quotations in NASDAQ and was listed in the "Pink Sheets" from long prior to the trade date, during the period of plaintiffs' distribution, and through the settlement date (Stipulation, Nos. 7, 8; A-102). During this period it had entered into contracts for the purchase and resale of White Shield stock, the consummation of which would have plainly violated Rule

10b-6, as interpreted in *Jaffee*. Under the law as interpreted, Faulkner had no choice but to cancel those contracts.*

The S.E.C. left no doubt in *Jaffee* that a market-maker who purchases distribution stock must "have terminated" his market-making as provided by Rule 10b-6, which contains only one such provision, the requirement that a participant in a distribution cease his bids or purchases ten, or in certain circumstances not relevant here, five business days *prior to* the commencement of the distribution. Rule 10b-6(a)(3) (clause 11). Thus, in *Jaffee,* the S.E.C. wrote as follows:

> "Persons, like [Greene & Co.], engaging in market-making activities in a security which at the same time is being offered in a registered distribution must not participate in such distribution unless they *have terminated* their bidding and purchasing in the open market as provided in Rule 10b-6" CCH ¶77, 805 at p. 83,859 (emphasis added).

In the instant case, unlike the market-maker in *Jaffee,* Faulkner could not, under any circumstances, have lawfully consummated its purchase. Plaintiffs have asserted that the very first conversation between the parties occurred on June 1, 1971 (a Tuesday), in a telephone call by Santangelo to Faulkner (Pltf's Brief, p. 71). See also, plaintiffs' Rule 9(g) Statement, ¶4 (A-201). Hence, it would not have been possible for Faulkner to have come within the exception of clause (11) of Rule 10b-6(a)(3), since the distribution commenced only four business days after that date.

It should also be noted that on June 7, 1971, Faulkner had resold 20,000 of the shares purchased to two other mar-

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*Faulkner's refusal to perform the contract was mandated by *Jaffee's* first holding, and was also mandated by *Jaffee's* second holding, because the stock was included in a registered offering.

ket-makers, which Faulkner could not cover by open market purchases (A-454-5). Moreover, Faulkner had entered quotations prior and subsequent to June 7, 1971 (Stipulation, Nos. 7, 8; A-102).

Accordingly, the only possible way for Faulkner to avoid violating Rule 10b-6 was for it to reject the stock.

Section 10(b) of the Securities Exchange Act of 1934 prohibits certain conduct "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." Rule 10b-6 is such a rule, and like the regulation in *La Bourgogne,* has the force of law. Indeed, a wilful violation of that Rule subjects the violator not only to civil sanctions and liabilities, but also to fine and imprisonment. 15 U.S.C. § 78ff.

Those subject to the regulations of the S.E.C. do not have the option of compliance or noncompliance. Nor do they have the option of deciding which regulations or administrative determinations are correct and should be followed, or incorrect, and to be ignored. A registered broker-dealer must comply with the regulations and determinations of the S.E.C., upon pain of suspension or forfeiture of its license and civil and criminal sanctions. Faulkner had no choice but to comply with Rule 10b-6, as interpreted in *Jaffee,* and to cancel its purchase and resale agreements, the consummation of which would have been plain violations of the Rule, as so interpreted. It is respectfully submitted that, under these circumstances, a holding that Faulkner is civilly liable to plaintiffs because the S.E.C. erred in deciding *Jaffee* is inconsistent with fundamental principles of fairness, equity and justice, the teaching of *La Bourgogne*, and the policies which gave rise to §23(a) of the Securities Exchange Act of 1934.

Moreover, principles of public policy also require that the defense based upon *Jaffee* be sustained. Rule 10b-6 was promulgated to protect the public against the evil of an

artificial securities market. Where the performance of a contract involves a violation of the securities laws, the public interest in the prevention of the violation is of greater importance than, and, where necessary, must override, the equities between the parties, *Kaiser-Frazer Corp.* v. *Otis & Co., supra,* even if, contrary to the facts here, the equities were to favor plaintiffs, whose agent wilfully violated Rule 10b-6, as interpreted.

It is submitted that these considerations also require that Faulkner's compliance with Rule 10b-6, as interpreted in *Jaffee,* afford it a complete defense, without regard to the answers to any of the following questions, all of which were raised by plaintiffs in the District Court: (a) the question of *Jaffee's* validity; (b) the question of whether Faulkner knowingly agreed to purchase distribution stock; and (c) the question of whether Faulkner actually relied on *Jaffee* in cancelling its purchase. Were liability to turn on the answers to such questions, the likelihood, risk and expense of litigation attendant upon cancellation of an apparently or actually illegal contract could well exceed the risk of detection and sanctions attendant upon its execution. A potential defendant might not choose, with Faulkner, compliance over the contract; the ultimate victims would be the public investors for whose interests the regulation was promulgated.

Hence, to permit even the possibility of liability for an act mandated by an administrative interpretation of a rule such as 10b-6 would not only be grossly unjust and completely inconsistent with principles of fairness and equity, but can only serve to encourage the conduct which the regulation was designed to prevent. It is thus respectfully submitted that Faulkner's compliance with Rule 10b-6, as interpreted in *Jaffee,* affords it a complete defense to plaintiffs' contract claim, whether or not *Jaffee* was correctly decided.

For each of the foregoing reasons, it is respectfully submitted that the District Court was in error in dismissing Faulkner's fourth affirmative defense, and that summary judgment should be granted to Faulkner on that defense.

POINT V

THE DISTRICT COURT ERRED IN GRANTING PLAINTIFFS' MOTION AND IN DENYING FAULKNER'S MOTION FOR SUMMARY JUDGMENT ON FAULKNER'S FIFTH AFFIRMATIVE DEFENSE

By Faulkner's fifth affirmative defense, Faulkner asserts that plaintiffs are precluded from any right of recovery because Faulkner, as a purchaser of a security in a registered distribution, was entitled to a reasonable time after receipt of the prospectus to read it before becoming finally committed to make the purchase. This defense is applicable even if the prospectus had contained no misstatements and had disclosed all material facts. There are no issues of fact as to this defense, and plaintiffs and Faulkner each moved for summary judgment thereon. The District Court denied Faulkner's motion and granted that of plaintiffs. It is submitted that the District Court was incorrect.

Faulkner purchased the White Shield stock from Tobey & Kirk as principal and not as a broker for clients. Although, on June 7, 1971 Faulkner immediately resold to two other brokers 20,000 of the 44,000 shares (Lattuga Transcript, p. 57; A-388), which resales were cancelled by Faulkner on June 15, 1971 immediately after the sale from Tobey & Kirk was cancelled (Stipulation, Nos. 25, 26; A-106), as between Tobey & Kirk and Faulkner, the purchase of the entire 44,000 shares was a purchase by Faulkner as principal (Stipulation, No. 9; A-102). Accordingly, Faulkner, like any other purchaser of registered

stock, had a right to read the prospectus upon receipt before becoming committed to accept the stock.

As set forth above, Mr. Ross admitted at the deposition of Tobey & Kirk that "red herring" prospectuses were not sent to Faulkner or to any of the other purchasers of the White Shield stock from Tobey & Kirk (Ross Transcript, pp. 49-50; A-230-1), and that a final prospectus was not delivered to Faulkner with the Tobey & Kirk confirmation of the sale to Faulkner (Ross Transcript, pp. 42-43; A-227-8) (Stipulation, Nos. 13, 19; A-103, 105).

Research has disclosed no case either granting or denying a purchaser of securities in a registered distribution the right to reject the stock within a reasonable time after receipt of a prospectus. The Securities Act of 1933 is completely silent on the point. However, it is respectfully submitted that the 1933 Act, which is designed to provide a purchaser with comprehensive disclosures in order to enable him to make an informed decision whether or not to purchase securities, would make absolutely no sense if the purchaser was legally committed to accept and to pay for stock before having seen the prospectus which contains the disclosures contemplated by the Act.

Plaintiffs' claim against Faulkner is based upon a contract which was admittedly made before Faulkner received a White Shield prospectus. It is submitted that upon receipt of the prospectus, Faulkner had a reasonable time to read it and determine whether or not it wished to make the purchase. The fact that Faulkner is a broker-dealer is irrelevant. Broker-dealers, like any other purchasers, are entitled to the protections of the Securities Act of 1933 and to the information contemplated by that Act; the Act provides no exceptions. Its provisions are designed for the protection of all purchasers, whether sophisticated or unsophisticated. *Newman* v. *Shearson*,

Hammill & Co., Inc., 383 F. Supp. 265 (W. D. Texas 1974).*

Thus, even if the White Shield prospectus contained adequate disclosures, Faulkner, like any other purchaser, had a right to reject the stock within a reasonable time after receipt of the prospectus. Whether or not Faulkner rejected the stock because the prospectus disclosed that plaintiffs were selling stockholders, or for any other reason, is irrelevant. The fact is that Faulkner rejected the stock within a reasonable time after receipt of the prospectus (actually, the rejection occurred instantly after receipt of the prospectus with the securities on June 15, 1971—Stipulation, No. 14; A-103), which, it is submitted, was its absolute right.

The primary purpose of the Securities Act of 1933 is to insure that prospective purchasers receive adequate information from which an informed decision can be made. If, at the time the prospective purchaser receives a prospectus, he is already legally committed to pay for the stock, what function does the prospectus serve? Is it simply a memento of his purchase?

The intent of Congress in adopting the Securities Act of 1933 was to insure that the prospectus is in the hands of the prospective purchaser before the sale becomes legally binding. As the Court observed in *Diskin* v. *Lomasney & Co., supra,* "Very likely Congress thought a better time for meaningful prospectus reading was at the time of the offer rather than in the context of a confirmation and demand for payment." 452 F. 2d at 876.

Absent a right to read the prospectus within a reasonable time after receipt and before the purchaser is legally obligated to purchase the stock, the entire statutory scheme

* A review of the transcripts of the depositions of the participants in the conversations leading to the sale to Faulkner and the cancellation thereof should dispel any impression that stock traders are more sophisticated than anyone else.

would be incongruous and would fail in its principal purpose. Thus, where an agreement to purchase has been made *before* the prospectus is sent, the only logical and sensible interpretation of the statute would require that the purchaser be given a reasonable time to read the prospectus before his obligation to purchase becomes fixed.

The District Court looked to § 12 of the 1933 Act and found that the right to rescind provided by that Section was limited to two specific circumstances—where a person offers or sells securities (a) in violation of § 5 of the Act, or (b) through the use of a material misrepresentation (Decision; A-21)—and concluded that the rights provided by that Section evidenced a Congressional intent to deny rescission in circumstances other than those set forth in that Section.

However, § 12 provides for a *cause of action* for rescission where a sale of securities has been made in violation of the statute. Faulkner never suggested that the District Court imply a *cause of action* in a circumstance not provided by § 12, but rather that the District Court interpret the 1933 Act in the only possible way to effectuate its basic purpose. That interpretation would be in no way inconsistent with the express statutory rights of action provided for in cases where the Act is violated.

This confusion of the District Court is evidenced by its analysis of *Diskin* v. *Lomasney & Co., supra,* in which the District Court noted that rescission was granted for a violation of the 1933 Act long after the purchaser received a prospectus. The District Court concluded that that case made clear that the purchaser need not exercise rescission rights promptly (Decision; A-21). However, the rescission right granted in that case was based upon a violation of § 12(1) of the 1933 Act, which permits a *cause of action* for rescission which can be commenced up to one year from the date of the violation. 15 U. S. C. § 77m.

It is submitted that, notwithstanding the express statu-

tory causes of action provided for violations of the 1933 Act, logic compels an interpretation of the statute which would permit a purchaser a reasonable time within which to read the prospectus before the sale becomes binding. It is submitted that any other interpretation would make the entire statute absurd—conferring rights to litigate where a prospectus is deficient, but denying a purchaser the right to make an informed decision whether or not to purchase where it is not.

The Securities and Exchange Commission has recognized the function of the statute in its regulations and releases requiring the distribution of preliminary prospectuses. Where a preliminary prospectus is delivered which contains the kind of information required by the 1933 Act, the purchaser is furnished with the kinds of disclosures contemplated by the Act and can make an informed decision prior to being legally committed to the contract. In that circumstance, an implied right to rescind would not be warranted.

Thus, Regulation § 230.460, CCH Fed. Sec. L. Rep. ¶ 3,860, provides in part:

> "(a) Pursuant to the statutory requirement that the Commission in ruling upon requests for acceleration of the effective date of a registration statement shall have due regard to the adequacy of the information respecting the issuer theretofore available to the public, the Commission will consider whether the persons making the offering have taken reasonable steps to make the information contained in the registration statement conveniently available to underwriters and dealers who it is reasonably anticipated will be invited to participate in the distribution of the security to be offered or sold.
>
> (b) As a minimum, reasonable steps to make the information conveniently available would in-

> volve the distribution, to each underwriter and dealer who it is reasonably anticipated will be invited to participate in the distribution of the security, a reasonable time in advance of the anticipated effective date of the registration statement, of as many copies of the proposed form of preliminary prospectus permitted by § 230.433 as appears to be reasonable to secure adequate distribution of the preliminary prospectus."

Notwithstanding the obvious purpose of that regulation, Tobey & Kirk, which had received the White Shield preliminary prospectuses prior to June 7, 1971, did not deliver it to any of its purchasers (Stipulation, Nos. 3, 19; A-100-1, 105).

It is submitted that, instead of leaving the preliminary prospectuses on Tobey & Kirk's shelves, Tobey & Kirk should have distributed them to its purchasers. It is further submitted that, for the reasons set forth above, these purchasers, including Faulkner, had a right to read the prospectus finally delivered to them before the sales became binding. As the Federal Trade Commission stated in 1933 (Release No. 33-70, 17 C. F. R. § 231.70, CCH Fed. Sec. L. Rep. ¶¶ 3150, 3153):

> "[The Securities Act of 1933] contemplates, beyond peradventure of doubt, the circulation of knowledge concerning the matters called for in the registration statement as a preliminary to the formation of an intelligent opinion as to the desirability of a particular security prior to the arrival of the time when it permits that now ripened opinion to express itself in an offer to purchase the security. It also looks forward to this ripened opinion proving either a barrier or a harbor for such seductive arts as may still be used after the expiration of the waiting period to sell the security." (at p. 3121)

For the foregoing reasons, it is respectfully submitted that Faulkner is entitled to summary judgment on its fifth affirmative defense.

POINT VI

THE DISTRICT COURT ERRED IN DENYING FAULKNER'S MOTION FOR SUMMARY JUDGMENT ON ITS SEVENTH AFFIRMATIVE DEFENSE

By Faulkner's seventh affirmative defense, Faulkner has asserted that plaintiffs failed to reoffer the securities rejected by Faulkner in the open market within a reasonable time after the cancellation and that, therefore, they failed to take any action to mitigate their alleged damages. Assuming the truth of plaintiffs' claims that the stock rejected by Faulkner was sold out in the open market between August 9, 1971 and September 28, 1971 (Stipulation, No. 28; A-107), there are no issues of fact as to this defense and, accordingly, it is respectfully submitted that Faulkner was entitled to summary judgment thereon. Plaintiffs and Faulkner each moved for summary judgment on this defense, but the District Court denied both motions (Decision; A-22).

Even if the Court were to resolve each of the issues of law set forth above in favor of plaintiffs, by reason of Faulkner's seventh affirmative defense, plaintiffs would nevertheless be limited in the amount of damages recoverable by them to $73,040; that amount is the product of 44,000 multiplied by $1.66, which is the difference between the contract price ($14.00 per share) and the market price on the settlement date, June 15, 1971, of $12.34 per share. Plaintiffs would be so limited because they did not sell out the stock rejected by Faulkner within a reasonable time. Plaintiffs have offered no justifiable excuse for not having done so. Indeed, as appears from the Stipulation, No. 29 (A-107-10), there were not less than 12 broker-dealers

regularly bidding for the stock every single day through the end of June 1971 and during July and August 1971. Thus, there was at all times a ready market for the White Shield stock.

It has been held that where a buyer breaches a contract for the sale of securities, the seller must resell the securities within a reasonable time in order to recover the difference between the contract price and the resale price. If the seller does not do so, he is limited to the difference between the contract price and the market value on the settlement date. *Bache & Company, Inc.* v. *International Controls Corp.*, 339 F. Supp. 341 (S. D. N. Y. 1972), *aff'd*, 469 F. 2d 696 (2d Cir. 1972).

The market price of the White Shield stock on June 15, 1971 was $12.34 per share, which is the mean between the mean reported bid prices and the mean reported asked prices for the stock on that date (A-73). Seventeen market-makers entered quotations in the "Pink Sheets" for the White Shield stock on June 15, 1971 (Stipulation, No. 29; A-107-10), in addition to Faulkner and other dealers which entered quotations in NASDAQ. Accordingly, the "Pink Sheet" quotations are overwhelming evidence of the market price on that date. See *Merritt, Vickers, Inc.* v. *S.E.C.*, 353 F. 2d 293, 296-7 (2d Cir. 1[illegible]).

The delay by plaintiffs here in reselling the stock far exceeded what might be construed to be a reasonable time. Any speculation by the plaintiffs on a rise in the market price of the stock was therefore at their expense, and not Faulkner's.

Plaintiffs have offered no valid reason why they did not sell out the rejected stock within a reasonable time, and the reasons offered by them for the delay have been proved to be invalid. Indeed, plaintiffs have stipulated to the facts establishing the invalidity of the reasons given by them for not having resold the stock within a reasonable time.

Thus, plaintiffs first contended that Faulkner notified Tobey & Kirk in writing of the cancellation on August 11, 1971 (See ¶ 8 of the State Court complaint, annexed as Exhibit A to their complaint herein), but they have subsequently admitted that there was no such August 11 notification and that written notice was given on June 16, 1971 (Stipulation, Nos. 15, 24; A-103, 106).

Then, plaintiffs had contended that there were negotiations with Faulkner attempting to resolve the dispute, although they offered no details of any such negotiations, and suggested that it was not until August 9, 1971 that it became evident that there would be no resolution. However, facts elicited in discovery in this action have proved that there were no such negotiations, nor were there any communications after June 23, 1971.

It is respectfully submitted that in the course of deciding weightier issues, the summary judgment motions on Faulkner's seventh affirmative defense were not given the consideration by the District Court they should have had. The District Court determined that the question of reasonableness is one of fact (Decision; A-22).

It is submitted that the question presented by the summary judgment motions on this defense was not one of reasonableness but one of the reason for the delay in making the resales. The settlement date was June 15, 1971. All discussions between the parties seeking a resolution of the dispute terminated on June 23, 1971. The resales were not commenced until August 9, 1971, although there were a large number of brokers regularly bidding for the stock every day during the interim.

The District Court pointed out that "plaintiffs argue that their conduct was reasonable" (Decision; A-22). It is submitted that plaintiffs have done nothing more than that —argue—and that was not a valid basis for denying Faulkner's summary judgment motion. Plaintiffs did not offer any evidentiary facts in opposition to Faulkner's motion,

but merely offered argument. Moreover, all of plaintiffs' excuses have been conclusively established to be false. The real reason for the delay in resales has been admitted.

Hence, in Answers dated July 18, 1973 by plaintiff Byrnes to Faulkner's Interrogatories, the following response was made to Interrogatory No. 16 (A-93-4):

> "(a) Byrnes notified Vincent Ross and Anthony Cueva, partners of Tobey & Kirk, that this was their problem, and urged them to get their lawyers to resolve it. There were numerous verbal communications between Byrnes and Ross during the period between June 15, 1971 and August 10, 1971. All of them were essentially requests for the status of the matter and of discussions with Faulkner, leading to the final report by Ross that Faulkner definitely would not accept the stock, and the advice that Byrnes begin to resell it."

Plaintiff Santangelo answered Interrogatories addressed to him with a substantially identical response (Answers dated July 24, 1973, No. 16; A-95).

Faulkner inquired of Tobey & Kirk as to the details of these alleged discussions between Faulkner and Tobey & Kirk. At the deposition of Tobey & Kirk, Mr. Ross testified that these alleged discussions were being conducted between attorneys on both sides, but no specific information was given (Ross Transcript, pp. 78-80; A-237-9). Interrogatories to Tobey & Kirk were then served by Faulkner to obtain the specific information. Tobey & Kirk finally answered following a motion under Fed. R. Civ. P. 37 to compel answers, and acknowledged that there were no such discussions (Tobey & Kirk's Answers to Faulkner's Interrogatories dated November 5, 1973, Nos. 4 and 5, and supplemental Answers dated November 26, 1974; A-96-8).

Following this acknowledgment, all parties hereto have agreed that the information given by Mr. Ross to plaintiffs

concerning these alleged discussions during the summer of 1971 was false, and that fact has been stipulated. Thus, in the Stipulation of Facts, the parties have agreed (No. 24; A-106) as follows:

> "24. All discussions or communications between Faulkner and either the plaintiffs or Tobey & Kirk, terminated, with respect to the transaction in suit, after a telephone conversation on June 23, 1971, between Marc Green, Esq. of Faulkner and Vincent Ross of Tobey & Kirk, in which Mr. Green confirmed to Mr. Ross his view that the transaction was illegal and that Faulkner could not accept the stock."

Nevertheless, in support of their motion for summary judgment on Faulkner's seventh affirmative defense, plaintiffs argued that the reason the resales were not commenced until August 9, 1971 was that Mr. Ross had informed them that discussions were continuing between the parties seeking a resolution of the dispute, and that they were not informed until early August 1971 that the dispute could not be resolved.

Thus, in plaintiff Byrnes' affidavit sworn to February 7, 1975 submitted in support of plaintiffs' summary judgment motion, the following appears (A-168):

> "16. During the summer of 1971 I remained in fairly regular contact with Messrs. Ross and Cueva [partners of Tobey & Kirk], and was repeatedly assured by them throughout July 1971 that discussions were still continuing between Tobey & Kirk's attorneys and Mr. Green, but that one of Tobey & Kirk's attorneys was away from the city during a part of that time, either on vacation or on business.
>
> 17. In early August, 1971, I was told by Mr. Ross that there was no further prospect of Faulkner's agreeing to accept the stock we had sold to it,

> and he advised me that we should commence to resell it over a period of time, since the market for the stock was still weak."

Plaintiff Santangelo's affidavit sworn to February 12, 1975 (¶¶ 8-9; A-177-8), confirms the quoted language in Byrnes' affidavit.

Hence, the reason for the delay in commencing the resales—the misinformation given to plaintiffs by their agent—has been plainly admitted and there is no question of fact as to why that delay occurred. Accordingly, plaintiffs are limited in damages to the difference between the contract price and the market price of the stock on the settlement date.

Both sides moved for summary judgment on Faulkner's seventh affirmative defense, acknowledging that all of the facts were before the Court from which a determination could be made. The motions were not made on the pleadings, but were made on a completed discovery record and stipulated facts. Faulkner offered evidentiary facts proving the reason for the delay, which facts were not rebutted.

Fed. R. Civ. P. 56(e) provides, in relevant part, as follows:

> "When a motion for summary judgment is made and supported as provided in this rule, an adverse party may not rest upon the mere allegations or denials of his pleading, *but his response,* by affidavits or as otherwise provided in this rule, *must set forth specific facts showing that there is a genuine issue for trial.* If he does not so respond, summary judgment, if appropriate, shall be entered against him." (emphasis added)

Plaintiffs did not set forth a single specific fact showing that there is a genuine issue for trial, and the facts appearing in the discovery record and Stipulation of Facts estab-

lish the reason, and the only reason, for the delay in the resales.

The foundation of their argument against Faulkner's seventh affirmative defense having been totally destroyed, plaintiffs resorted to a trilogy of untenable excuses for having failed to sell out within a reasonable time, none of which is even arguably sufficient to preclude summary judgment to Faulkner.

First, they say June 23, 1971 was the earliest date that the stock should have been resold (Pltfs' Brief, p. 83), because it was not until that date that all communications terminated. Apart from the fact that Faulkner's advice on June 23 was simply a reiteration of the advice it had given on June 15 and June 21 that the transaction was illegal (Stipulation, Nos. 21-24; A-105-6), plaintiffs' argument is based upon a misconstruction of the law. Had the stock been sold out on June 23, plaintiffs could have contended that it was sold out within a reasonable time. *But that did not occur,* and accordingly, plaintiffs' damages are limited by the market price on the settlement date, because, as will hereinafter appear, when stock is not sold out within a reasonable time, damages are limited by the market price on the settlement date, and not by the market price on a date which would have been within a reasonable time had the sale in fact occurred on such latter date.

The second excuse given is based upon Mr. Ross' testimony that during the summer of 1971 "the stock was depressed and there was [sic] not any sizeable bids in the stock around the summer months" (Ross Transcript, pp. 107-08; A-252-3). That excuse is demonstrably insufficient, for two reasons.

First, Faulkner offered, and plaintiffs stipulated to, evidence of extensive bidding for White Shield stock every day. Contrary to the requirements of Fed. R. Civ. P. 56(e), which insists upon *facts,* plaintiffs have offered only con-

clusory remarks about the state of the market in the summer of 1971 and the salability of their stock. Mr. Ross' conclusory testimony is not equivalent to "specific facts" required by Rule 56(e).

Second, even if Mr. Ross' statements were true, they could not have provided plaintiffs with a valid excuse for delaying the commencement of their sales. It may be that there were no "sizeable" bids, but there were many bids every day. Plaintiffs may not have been able to dispose of their stock in a single sale, but they could have commenced selling in June 1971 in the very same way they commenced selling in August. (See schedule entitled "Actual Re-Sales against Pink Sheet Quotes," Pltfs' Brief, p. 147). They did not do so for reasons admittedly unrelated to market factors.

Had plaintiffs sold their stock within a reasonable time in a commercially reasonable manner, their actual damages may well have been different from the measure prescribed by New York law and hereinafter discussed. They may not be heard to argue that their damages should be measured by the prices they would have received for their stock had they sold within a reasonable time in a commercially reasonable manner—a measure which, because of plaintiffs' delay, can only be determined by conjecture—because that is not what occurred. Accordingly, as will hereinafter appear, their damages must be measured by the market price on the settlement date.

The third excuse merits plaintiffs an award for ingenuity. They claim (Pltfs' Brief, pp. 90-91) that Faulkner made their stock unsalable by spreading rumors about its lack of cleanliness. That argument, which is obviously born of desperation, is unsupported by any evidence, unless Ross' conclusory statement to that effect be considered evidence, and again overlooks the now admitted reason why plaintiffs did not attempt to sell-out their stock.

Moreover, that excuse is legally insufficient. Plaintiffs could have sold-out their stock through any broker. The purchasers would not have known the identities of the owners. Accordingly, this preposterous contention that their stock was "tainted", even if true, could not have affected plaintiffs' ability to dispose of it, had they attempted to do so, which they admittedly did not.

Bache & Company, Inc. v. *International Controls Corp., supra,* held that despite the exclusion of the term "investment securities" from the definition of "goods" under the Uniform Commercial Code, Article 2 of the U. C. C. is nevertheless applicable to determine the measure of damages for breach of a contract for the sale of securities, and that if the seller does not resell within a reasonable time, the damages recoverable by him are limited to the difference between the contract price and the market price at the time and place for tender. The *Bache* Court observed that there is no clear-cut rule on what constitutes a commercially reasonable time and that "one can only say that the resale should be made as soon as practicable after the breach of the tender offer and the seller should make every reasonable effort to minimize his loss." 339 F. Supp. at 352.

In *Bache,* the defendant purchasers breached a contract for the purchase of securities. Some of the securities were resold for the account of the purchasers. The jury determined that the defendants were liable on the contract and only the question of damages remained. Citing cases, the Court held that Article 2 of the U. C. C. was applicable to the question of damages for breach of a contract for the sale of securities. Under U. C. C. § 2-706, the plaintiff had the right to resell within a reasonable time. Comment 2 to that Section points out that when a seller does not resell within a reasonable time, he is limited to his damages under § 2-708, i.e., the difference between the market price at the time and place of tender and the unpaid contract price.

Comment 5 to U. C. C. § 2-706(2) indicates that what constitutes a reasonable time depends upon the goods, the market and the other circumstances of the case rather than a strict legal yardstick.

The *Bache* Court looked to cases involving the conversion by a broker of a client's securities for guidelines to determine, by analogy, a reasonable time for the exercise of the right to resell securities where the buyer breaches the contract of sale. In these cases, the question in issue was what constituted a reasonable time for plaintiff to *repurchase* converted securities.

In *Phillips* v. *Bank of Athens Trust Co.*, 202 Misc. 698, 119 N. Y. S. 2d 47 (Sup. Ct. 1952), one week was determined to be the maximum reasonable time. The Court noted that the market had begun to rise after the conversion complained of, suggesting that a market movement which permitted plaintiff to speculate at defendant's expense operated to reduce the period of time required for the plaintiff to act.

In *Gelb* v. *Zimet Bros., Inc.*, 34 Misc. 2d 401, 228 N. Y. S. 2d 111 (Sup. Ct. 1962), *aff'd*, 237 N. Y. S. 2d 989 (App. Div. 1st Dep't 1963), 24 days was determined to be an unreasonably long time, even though the plaintiff was on vacation in Hawaii at the time he learned of the conversion, because he had ample opportunity after he returned to purchase stock and to finance the transaction.

Mayer v. *Monzo*, 221 N. Y. 442 (1917) did not hold, as plaintiffs suggest (Pltfs' Brief, p. 84), that a period of 60 days is reasonable. The decision in that case referred to other cases in which various periods had been held to be reasonable in particular circumstances, and held that the question of when the defendant first received notice that his stock had been converted was a question of fact for the jury. No similar question of fact appears here—plaintiffs admittedly learned that Faulkner had rejected the stock immediately after the rejection.

The *Bache* Court considered the fact that large blocks of stock were involved and that the owners of the securities, Bache's customers, were scattered throughout the country. Each owner had to be notified and each had to make a separate decision concerning the resale and then notify Bache of that decision. The Court found that a 30-day period to resell the stock was the maximum period considered reasonable under the circumstances in that case, but that stock sold thereafter was not sold within a reasonable time.

Moreover, there are good reasons why the time limits in cases involving breach of a contract for the sale of securities should be significantly shorter than those applicable in conversion cases. The determination of a reasonable time in conversion cases is based on factors relating to the time reasonably required by the plaintiff to consult counsel, to employ other brokers, to watch the market to determine whether it is advisable to repurchase, and to raise funds if he decides to do so. *Rosenbaum* v. *Stiebel,* 137 App. Div. 912, 122 N. Y. S. 131, 134 (1st Dep't 1910); *Burhorn* v. *Lockwood,* 71 App. Div. 301, 75 N. Y. S. 828, 831 (1st Dep't 1902), *appeal dismissed,* 177 N. Y. 539 (1903); *Gelb* v. *Zimet Bros., Inc., supra.* These factors are not present in sales cases: the seller has already made his decision to sell; he need not change brokers as he must where his broker was the convertor; and he does not need to raise funds to sell the securities.

In arguing that they are entitled to summary judgment on Faulkner's seventh affirmative defense, plaintiffs erroneously seek to invoke two provisions of the Uniform Commercial Code of New York.

First, they seek to invoke U. C. C. § 8-107(2), (62½ McKinney 1964) which reads as follows:

> "(2) Where, pursuant to a contract to sell or a sale, a security has been delivered or tendered to the purchaser, and the purchaser wrongfully fails

> to pay for the security according to the terms of the contract or the sale, the seller may as an alternative to any other remedy recover the agreed price of the security. This subsection does not affect the remedy of a seller if the security has not been delivered or tendered."

That provision is plainly inapplicable for several reasons. First, plaintiffs have not sued to recover the agreed price of the security. As clearly indicated by that statute, the remedy provided thereby is "an alternative to any other remedy." As noted in the Practice Commentary by the late Carlos L. Israels,

> "the remedy of suit for the price may be elected only 'as an alternative to any other remedy'. It will presumably involve appropriate provision for holding the securities and any distributions thereon for account of the purchaser pending the outcome of the litigation, and the continuing risk of the solvency of the defaulting buyer."

Here, plaintiffs have not elected to assume the risk of holding the securities and to sue for the purchase price, and accordingly, may not recover under that statute.

Plaintiffs next cite U. C. C. § 2-708(2), which provides, in essence, for the recovery of the "profit" where the measure of damages provided for by § 2-708(1) is inadequate to put the seller in as good a position as performance would have done.

Plaintiffs' reliance on § 2-708(2) is plainly misplaced, notwithstanding their assertion that Faulkner kept plaintiffs "dangling" for a period formerly alleged to be nearly two months but now alleged to be one week, before "finally" asserting that the transaction was illegal (Pltfs' Brief, p. 85). Section 2-708(2) permits a manufacturer to recover lost profits without regard to market price since he has lost

a sale. Similarly, it permits dealers having "an unlimited supply of fixed price goods" to recover the profits of a lost sale where no damages might otherwise be cognizable, since the contract, resale, and market price may be identical. *Neri v. Retail Marine Corp.*, 30 N. Y. 2d 393, 398-400, 334 N. Y. S. 2d 165, 169-70 (1972). The circumstances contemplated by that subsection are not remotely applicable here, even apart from the facts that plaintiffs have not sued to recover their "profit", if any, and have offered no evidence thereon.

Plaintiffs also erroneously invoke N. A. S. D. Emergency Rule of Fair Practice No. 70-2 (Pltfs' Brief, p. 84), which requires N. A. S. D. members to "clear" on their books a "fail to deliver" or "fail to receive" account (which is comparable to a late account receivable) within 30 days after it reaches 60 days in age. That rule is not remotely germane. There was no "fail" involved here. Faulkner rejected the stock when delivery was tendered. Indeed, as will be seen from the discussion of Faulkner's ninth affirmative defense (Point VII, *infra*), the N. A. S. D. Rules pertaining to liquidation of a contract where stock is rejected require that the stock be sold out promptly, and in no event later than three business days after the rejection.

Plaintiffs had at all times a readily available market for their stock. Faulkner did not keep them "dangling". On the contrary, instead of liquidating the contract, plaintiffs attempted to persuade Faulkner to accept the stock, and were unambiguously informed that Faulkner would not participate in an unlawful transaction (Stipulation, Nos. 21-24; A-105-6). Moreover, even after they ceased "dangling", plaintiffs failed to avail themselves of the market for only one reason—the misinformation given to them by their agent that a resolution of the dispute was being negotiated. While plaintiffs may argue that under the circumstances, their delay was reasonable, they must be charged with the consequences of their agent's acts—acts which

cannot be argued to be reasonable. Accordingly, plaintiffs are limited in the damages recoverable by the market price on the settlement date.

It is apparent that when plaintiffs commenced the State Court Action they believed that the resales were delayed because Tobey & Kirk or its attorneys were negotiating with Faulkner. However, after the facts were established, plaintiffs contrived a series of untenable excuses in order to avoid the consequences of the delay.

Plaintiffs succeeded in confusing the District Court by their arguments; to compound this confusion, they reached for patently inapplicable provisions from the Uniform Commercial Code and N. A. S. D. Emergency Rules requiring clearance of "fails". However, plaintiffs' arguments, which they continue to press before this Court, are demonstrably insufficient for the reasons set forth above.

For the foregoing reasons, it is again respectfully submitted that the District Court was incorrect in denying summary judgment to Faulkner on its seventh affirmative defense.

POINT VII

THE DISTRICT COURT ERRED IN GRANTING PLAINTIFFS' MOTION AND IN DENYING FAULKNER'S MOTION FOR SUMMARY JUDGMENT ON FAULKNER'S NINTH AFFIRMATIVE DEFENSE

By Faulkner's ninth affirmative defense, Faulkner has asserted that plaintiffs are not entitled to recovery on their claim against Faulkner because Tobey & Kirk failed to comply with the rules of the National Association of Securities Dealers Inc., of which both Faulkner and Tobey & Kirk were member firms. There are no issues of fact with respect to Faulkner's ninth affirmative defense, and plaintiffs and Faulkner each moved for summary judgment thereon. The District Court denied Faulkner's motion and granted that of plaintiffs. It is submitted that the District Court was incorrect.

The Tobey & Kirk confirmation of the sale to Faulkner did not indicate that the stock was included in a registration statement, as required by Section 10 of the N. A. S. D. Uniform Practice Code (Stipulation, No. 13; A-103); nor did Faulkner's confirmation to Tobey & Kirk (A-448). Therefore, it is submitted that plaintiffs do not even have an enforceable contract for the sale of such stock.

And, after the rejection of the stock by Faulkner on June 15, 1971, Faulkner sent a "DK" notice to Tobey & Kirk, which was received by Tobey & Kirk on June 16, 1971 (Stipulation, No. 15; A-103). "DK" is the abbreviation for "Don't Know". By the notice, Faulkner informed Tobey & Kirk that it had no knowledge of a transaction for the sale to it of *registered* securities. See Uniform Practice Code, § 9(c).

However, although plaintiffs contend the stock rejected by Faulkner was sold out by Tobey & Kirk between August 9 and September 28, 1971, they have admitted that no notice was ever given to Faulkner of the resales nor was any statement ever made to Faulkner that the resales were for the account of Faulkner or that Faulkner would be liable for the difference between the contract price and the resale prices (Stipulation, No. 30; A-111).

Because Tobey & Kirk and Faulkner were both N. A. S. D. members, they were required to comply with the N. A. S. D. rules with respect to resales. In that regard, Section 60 of the Uniform Practice Code of the N. A. S. D. provides as follows:

> "(a) Upon failure of the buyer to accept delivery in accordance with the terms of the contract, and lacking a properly executed Reclamation or Rejection Form (Form #801) meeting the requirements prescribed in Section 52 of this Code, the seller may, without notice, 'sell-out' in the best available market and for the account and liability of the

party in default all or any part of the securities due or deliverable under the contract.

Notice of 'sell-out'

(b) The party executing a 'sell-out' as prescribed above shall, as promptly as possible on the day of execution, via hand delivery, telegram, TWX, or other comparable written media, notify the broker/dealer for whose account and risk such securities were sold of the quantity sold and the price received, and shall promptly mail or deliver formal confirmation of such sale."

The stock was not sold out in accordance with the N. A. S. D. rules. No notice was sent to Faulkner that the resales were for its own account as required by Section 60, nor was any formal or any other kind of confirmation of any such sale ever sent to Faulkner. In fact, no communications were ever made to Faulkner until July, 1972, more than one year after the cancellation, when plaintiffs commenced the State Court Action.

Plaintiffs argued to the District Court that Faulkner should have sent a Uniform Rejection Form #801 instead of a "DK" notice. Plaintiffs were incorrect, since a Rejection Form is one which accompanies securities which have been accepted and are thereafter returned (See Section 52 of the N. A. S. D. Uniform Practice Code), and the White Shield stock had never been accepted by Faulkner. In any event, the message communicated by Faulkner by its notice is not disputed, and quibbling over the form used to confirm that message does not in any respect change the result.

Moreover, even if plaintiffs were correct that a Rejection Form should have been sent to Tobey & Kirk rather than a DK notice, they would nevertheless not prevail, because Section 52(b) of the Uniform Practice Code re-

quired Tobey & Kirk to sell out the White Shield stock within three business days of the rejection. Thus, Section 52(b), as then in effect, provided:

> "Absence of Form Permits Sell-Out
>
> (b) Any security reclaimed or returned on a transaction *without a properly executed Reclamation or Rejection Form* as prescribed within this section may, at the option of the receiving broker, be 'sold-out' pursuant to Section 60 of this Code, however, *in no event later than three business days* after receipt of the security by the receiving broker or his agent." (emphasis added)

And by Section 60, where a Rejection Form is not sent, the broker selling out must give notice to the rejecting broker of the sale if the securities are sold for the account and risk of the rejecting broker. Admittedly, this was not done here. Therefore, the stock was not sold-out for Faulkner's account, but was sold for the account and risk of plaintiffs.

The disposition by Tobey & Kirk of the rejection of the White Shield stock by Singer underscores the invalidity of plaintiffs' position. Singer rejected the White Shield stock sold to it by Tobey & Kirk on June 16, 1971, and on June 17, Singer sent Tobey & Kirk a Rejection Form #801 which stated "Trade Cancelled—Shelf Registration Stock" (Stipulation, No. 27; A-107). When Singer's stock was sold out, Tobey & Kirk sent Singer a notice of the sale which stated that the sale was for Singer's account (Ross Transcript, pp. 73-4; Exhibits I and J identified at the deposition of Tobey & Kirk (see Record Document No. 58A)). But although there were apparently no communications at all between plaintiffs or Tobey & Kirk with Singer, those sales were not even commenced until Sep-

tember 17, 1971, *a full three months after the Rejection Form was sent* (Stipulation, No. 28; A-107).

It is submitted that none of the alleged resales were for Faulkner's account but were for the account of plaintiffs, and that the loss on the resales must be borne by the plaintiffs and not by Faulkner. Had plaintiffs intended to seek to impose liability on Faulkner for the loss on the resales, it is submitted that the resales should have been made within the three business days provided by the rules and that notice to that effect would and should have been given in accordance with the N. A. S. D. rules. Accordingly, it is respectfully submitted that plaintiffs are precluded from recovering from Faulkner the difference between the contract price and the resale prices, and that Faulkner was therefore entitled to summary judgment with respect to its ninth affirmative defense.

In its determination of the second affirmative defense, the District Court recognized that in structuring the sale to Faulkner as a sale by a broker—Tobey & Kirk—the requirements of the Securities Act of 1933 to a sale so structured were applicable, although the prospectus delivery requirement might not have been applicable had the plaintiffs made the sale to Faulkner directly and had not sent a confirmation of the sale to Faulkner (Decision; A-13).

However, in its determination on the ninth affirmative defense, the District Court expressly determined that plaintiffs' rights do not depend on their broker's compliance with N. A. S. D. rules (Decision; A-23).

It is submitted that the District Court was incorrect. The N. A. S. D. rules were designed to regulate the conduct of N. A. S. D. member firms. The prompt sell-out and notice of sell-out requirements were not designed, as the District Court determined, "to protect the party whose contract has been breached" (Decision; A-23). On the contrary, they were designed to protect the party in breach from speculation in price fluctuation by the party whose contract has

been breached, and to minimize damages. Had Tobey & Kirk complied with the applicable rules, the damages sustained by plaintiffs, for which liability against Faulkner is sought, would have been substantially reduced. Moreover, had Tobey & Kirk delivered a confirmation of the sale to Faulkner showing that the stock being sold was registered stock, as required by Section 10 of the N. A. S. D. Uniform Practice Code, Faulkner could and would have cancelled immediately, before the price of the stock declined, so that damages may have been avoided entirely.

Plaintiffs structured the transaction as a sale by their broker. Plaintiff Santangelo was a disclosed principal and plaintiff Byrnes was an undisclosed principal (McMillen Transcript, pp. 14, 75-76; A-269, 310-11). Although plaintiffs themselves have brought suit, any defense Faulkner has against their agent may also be asserted against them. The District Court correctly so determined in its ruling on Faulkner's second affirmative defense. It is submitted that the District Court incorrectly reached a contrary and inconsistent conclusion with respect to Faulkner's ninth affirmative defense.

Ignoring Section 1(a) of the Uniform Practice Code, which states that all over-the-counter transactions in securities between member firms (with certain exceptions not relevant here) shall be subject to the provisions of this Code, the District Court noted that Section 1(b) of the Uniform Practice Code provides that "failure to deliver securities sold, or failure to pay for securities as delivered, on or after the settlement date, does not effect a cancellation of the contract. The remedy for the buyer or seller is provided by Sections 59 and 60 respectively." (Decision; A-23). Section 1(b) actually includes, after the word "respectively", the words "unless the parties mutually consent to cancellation of the trade."

It is submitted that Section 1(b) is not applicable to the facts in issue. Faulkner did not fail to pay for securities

as delivered. Faulkner actually rejected the stock and, accordingly, did not accept delivery. Accordingly, there was a cancellation of the contract.

The District Court concluded that the failure to follow the procedures prescribed by Sections 59 and 60 not only did not effect cancellation of the contract, but had no effect whatever. The District Court determined that those sections are permissive and need not be complied with (Decision; A-23). The District Court's ruling essentially determined that the N. A. S. D. rules were without any effect—that member firms may comply with them if they so choose, but need not, without any consequence to the contract, any remedies in connection therewith, or the amount of damages.

Admittedly, the failure to comply with the sell-out and notice of sell-out requirements of Section 60 did not effect a cancellation of the contract; the contract had already been cancelled. And, admittedly, the procedures prescribed by Section 60 are permissive. However, if the injured broker elects to hold the broker in breach liable, it must follow the procedures prescribed by Section 60. The injured broker is not required to follow those procedures, but if it does not do so, it may not impose liability on the broker in breach. That is the permissive nature of Section 60.

Moreover, the prompt sell-out and notice of sell-out requirements were designed to minimize damages. In its ruling on the ninth affirmative defense, the District Court determined that the plaintiffs may recover their claimed damages far in excess of those which otherwise would have been recoverable had Tobey & Kirk complied with those procedures. Thus, although the failure to comply with Section 60 may not effect a cancellation of the contract, it surely should limit the right to recover damages in excess of those which would have been recoverable had that Section been complied with.

Further, the District Court did not even address the fact that Tobey & Kirk had failed to identify the stock

being sold as registered stock in its confirmation of the sale (A-449) as required by Section 10 of the Uniform Practice Code. That Section is not "permissive", but rather prescribes the kind of information which confirmations or comparisons "shall include", including information as to whether or not the stock is "registered". Had Tobey & Kirk complied with the requirements of that Section, the entire dispute could have been avoided immediately after the trade date—June 7, 1971. The District Court in effect held that, notwithstanding Tobey & Kirk's failure to properly identify the stock as registered stock as directed by the Uniform Practice Code, Faulkner could nevertheless be held liable for the full amount of damages claimed by the plaintiffs.

The contract for the purchase and sale of plaintiffs' White Shield stock was a contract between Faulkner and Tobey & Kirk, both of which were N. A. S. D. member firms. Tobey & Kirk failed to comply with the N. A. S. D. rules in connection with the confirmation and liquidation of that contract. Had Tobey & Kirk complied with those rules, the dispute would have been entirely avoided and, in any event, the damages claimed would have been substantially reduced.

Had plaintiffs sold the stock to Faulkner directly without interposing Tobey & Kirk, they would not have had to comply with the N. A. S. D. rules. "But that is not the way the transaction took place, and the plaintiffs will not be heard to argue that they could have avoided an unfavorable result by structuring their affairs differently", as the District Court noted in its ruling on Faulkner's second affirmative defense (Decision; A-13).

It is respectfully submitted that the ruling of the District Court on Faulkner's ninth affirmative defense was incorrect, and that Faulkner was entitled to summary judgment on that defense.

POINT VIII

THE DISTRICT COURT PROPERLY DISMISSED PLAINTIFFS' COUNTERCLAIM AND FAULKNER'S FIRST COUNTERCLAIM

By Faulkner's first counterclaim, Faulkner sought a declaratory judgment that its affirmative defenses are valid and sufficient in law and preclude plaintiffs from any right of recovery against Faulkner in the State Court Action or herein. By plaintiffs' counterclaim asserted in plaintiffs' reply to Faulkner's counterclaims, plaintiffs seek (a) a recovery from Faulkner for breach of contract, and (b) a declaratory judgment that Faulkner's nine affirmative defenses are insufficient in law.

Except for plaintiffs' contract claim, neither of these counterclaims have any independent significance, since they merely seek a declaration of the validity or invalidity of defenses which were already determined by the District Court. A contrary disposition by this Court as to any of the defenses will not change that result, since this Court, like the District Court, can rule on the defenses directly and will have no occasion to grant a judgment "declaring" that an affirmative defense is either sufficient or insufficient. Thus, these counterclaims for declaratory judgments are academic, and were properly dismissed by the District Court. And insofar as plaintiffs' counterclaim seeks a recovery for breach of contract, it was disposed of by the February 26, 1976 Decision, as amended, of the District Court, which granted summary judgment to Faulkner on its second affirmative defense, which thereby barred plaintiffs from any recovery on their contract claim against Faulkner.

Accordingly, the Judgment of the District Court, entered May 10, 1976, dismissed Faulkner's first counterclaim and plaintiffs' counterclaim against Faulkner. If this Court concludes that Faulkner is entitled to summary judg-

ment on any of its affirmative defenses other than the seventh, which relates to the measure of damages, it is submitted that the Judgment of the District Court dismissing plaintiffs' counterclaim must be affirmed.

POINT IX

THE DISTRICT COURT ERRED IN DISMISSING FAULKNER'S SECOND AND THIRD COUNTERCLAIMS

By Faulkner's second counterclaim, Faulkner seeks to recover its losses sustained by reason of the violation by plaintiffs and Tobey & Kirk of Rule 10b-6. By Faulkner's third counterclaim, Faulkner seeks to recover its losses sustained by reason of the violations by plaintiffs and Tobey & Kirk of Rule 10b-5, § 352-c of the New York General Business Law and Faulkner's rights under common law.

Because of the disputed factual issues discussed in connection with Faulkner's first affirmative defense, Faulkner did not move for summary judgment on its second or third counterclaims, and opposed plaintiffs' and Tobey & Kirk's motions for summary judgment thereon. Faulkner's second counterclaim, predicated on Rule 10b-6, was dismissed for the same reasons as were set forth with respect to Faulkner's fourth affirmative defense. Summary judgment was not granted on Faulkner's third counterclaim, predicated on alleged fraud and breach of contract, in the original Decision of the District Court dated February 26, 1976. However, by the Amended Decision of the District Court dated April 8, 1976, summary judgment on that counterclaim was granted following a motion for reargument by plaintiffs in which they asserted that Faulkner had not sustained any compensable damages and thus had no basis for any affirmative claim (A-457).

Plaintiffs argued that Faulkner's loss on the cancelled resales is not a cognizable item of damages. However, as will hereinafter appear, Faulkner is entitled to recover on

its second counterclaim the loss it sustained in reliance upon its contract with plaintiffs, including losses on the resales which it was forced to cancel. Further, by its third counterclaim, Faulkner is entitled to recover the aforementioned losses, and also its litigation expenses, including attorneys' fees, which Faulkner has been required to incur to prove the fraud and to defend against plaintiffs' attempts to enforce an unlawful agreement in the District Court and in the State Court Action, as well as punitive damages.

A. Loss on the Cancelled Resales

Plaintiffs characterized Faulkner's lost markup on the cancelled resales to Singer and to Mitchum as something too remote and speculative to allow recovery by denominating it a loss of "anticipated profits." However, the loss sustained by Faulkner on the cancelled resales was an actual, certain and foreseeable result of the fraud by plaintiffs and Tobey & Kirk, who knew that Faulkner was making a market in White Shield stock and thus purchased the stock for resale in the ordinary course of its business. The loss was thus an item of consequential damages recoverable to a "defrauded buyer" under *Zeller* v. *Bogue Electric Mfg. Co.*, 476 F. 2d 795, 803 (2d Cir.), *cert. denied,* 414 U. S. 908 (1973); *Commerce Reporting Co.* v. *Puretec, Inc.*, 290 F. Supp. 715, 718-19 (S. D. N. Y. 1968).

Moreover, in addition to being a "defrauded buyer", Faulkner was a "defrauded seller", since it would not have entered into the resale agreements but for the fraud. See 2 A. Bromberg, *Securities Law: Fraud,* § 8.5 p. 521.

But whether Faulkner was a defrauded buyer or a defrauded seller, or both, it is entitled to recover the loss on the cancelled resales as consequential damages resulting from the fraud under the principles enunciated in *Zeller*. That case held that a defrauded buyer, as well as a defrauded seller, is entitled to recover consequential damages

for fraud in a private civil action for damages under § 10(b) of the Securities Exchange Act of 1934.

Plaintiffs argued to the District Court that Faulkner could not recover its consequential damages on the cancelled resales because that loss was more than offset by the price decline which reduced the value of the 24,000 shares not resold by Faulkner. Thus, plaintiffs argued, the loss to Faulkner on the cancelled resales was exceeded by the amount saved by Faulkner in cancelling its contract with plaintiffs, notwithstanding the fact that it was very likely the unlawful distribution of a large block of the stock which caused or contributed to the price decline. And this distribution was unlawful, even if, *arguendo,* the District Court was correct in determining that Faulkner's purchase of 44,000 shares for resale did not make it a participant in that distribution.

Plaintiffs thus sought a credit against damages for the price decline in the stock most likely attributable to their own conduct and that of Tobey & Kirk. Thus, having presumptively destroyed the market price as an accurate indicator of value, plaintiffs in effect profited further therefrom in successfully persuading the District Court to employ that market price on the settlement date as a measure in arguing that Faulkner did not sustain a loss on the transaction. At the very least, the burden rests on plaintiffs to demonstrate that their *per se* violation of a rule designed to prohibit the artificial distortion of a free market--Rule 10b-6—did not in fact cause or contribute to the distortion.* If this burden should prove difficult, it is only because plain-

* The justification for such a burden has been recognized since at least the time of the "Chimney Sweeper's Jewel Case" (*Armory* v. *Delamirie,* 1722, 1 Strange 505), in which the Chief Judge directed the jury that "unless the defendant did produce the jewel, and shew it not to be of the finest water, they should presume the strongest against him, and make the value of the best jewels the measure of their damages." The same principles are applicable in determining damages in actions under the federal securities laws. *Gratz* v. *Claughton,* 187 F. 2d 46, 51-52 (2d Cir.), *cert. denied,* 341 U. S. 920 (1951).

tiffs by their own wrongdoing destroyed the most reliable indicator of value—a market free from manipulative practices.

As plaintiffs have correctly noted (Pltfs' Brief, pp. 93-4), any difficulties in the computation of damages are to be resolved against the wrongdoer who has created those difficulties. *Bigelow* v. *RKO Radio Pictures, Inc.*, 327 U. S. 251, 264 (1946); *Eastman Kodak Co.* v. *Southern Photo Materials Co.*, 273 U. S. 359, 379 (1927); *Sarlie* v. *E. L. Bruce Co.*, 265 F. Supp. 371, 376 (S. D. N. Y. 1967), cited with approval in *Chasins* v. *Smith, Barney & Co.*, 438 F. 2d 1167, 1173 (2d Cir. 1970).

B. Out-of-Pocket Expenses

Faulkner's out-of-pocket expenses include postage, handling, and telephone expenditures in anticipation of delivery and also expenses of a similar nature necessitated by the cancellation of the purchase and resales. Had plaintiffs disclosed that the stock offered to Faulkner was distribution stock, rather than representing precisely the contrary to Faulkner, Faulkner would not have entered into the contracts of purchase and resale and would not have incurred these expenses. Thus, the incidental expenses are clearly recoverable without regard to whether consummation of the contracts would have been profitable or unprofitable. *Gruber* v. *S-M News Company, Inc.*, 126 F. Supp. 442, 446 and n. 6 (S. D. N. Y. 1954) (distinguishing recovery of incidental expenses in a fraud action from recovery of such expenses in a contract action).

Faulkner did not move for summary judgment on its third counterclaim because, as the District Court held (A-8-9) there were disputed issues of fact. Accordingly, Faulkner had no occasion to offer evidence of the specific amount of its out-of-pocket expenses. However, the record and the Stipulation of Facts show the use of the mails and telephones by Faulkner on several occasions (see, e. g., Stipula-

tion, Nos. 12, 15; A-5). Plaintiffs did not offer any evidence at all on the issue of Faulkner's damages, other than the market prices of the White Shield stock. It is submitted that the Amended Decision of the District Court, which in effect determined as a matter of law either that Faulkner did not sustain any out-of-pocket expenses in connection with the transactions and cancellations thereof, or that Faulkner could not recover such expenses, and accordingly granted summary judgment dismissing Faulkner's third counterclaim, was plainly erroneous.

C. Damages for Common Law Fraud and under G. B. L. § 352-c

By its third counterclaim Faulkner also seeks to recover actual and punitive damages under pendent causes of action asserted under the law of New York. Actual damages sought include the aforementioned out-of-pocket expenses, loss on the cancelled resales, and litigation expenses.

The loss on the cancellations is recoverable under Faulkner's claims based on common law fraud. *Lev* v. *Aamco Automatic Transmissions, Inc.*, 289 F. Supp. 669, 671 (E. D. N. Y. 1968); *La Veglia* v. *Guidice,* 278 App. Div. 669, 102 N. Y. S. 2d 768 (2d Dep't 1951); *Delehanty* v. *Walzer,* 59 N. Y. S. 2d 777, 789-90 (Sup. Ct. 1945), *rev'd on other grounds,* 271 App. Div. 886, 67 N. Y. S. 2d 25 (2d Dep't 1946), *aff'd,* 298 N. Y. 820, 83 N. E. 2d 863 (1949).

Further, Faulkner's counterclaims state a cause of action arising out of the violation by plaintiffs and Tobey & Kirk of § 352-c of the General Business Law of the State of New York, which makes "illegal" certain conduct pertaining to securities transactions. The New York Courts imply a civil cause of action from a statute, such as § 352-c, which is designed to protect the public. *American Bank & Trust Co.* v. *Barad Shaff Securities Corp.*,

335 F. Supp. 1276 (S. D. N. Y. 1972); *Lupardo* v. *I. N. M. Industries Corp,* 36 F. R. D. 438 (S. D. N. Y. 1965). And plaintiffs' attempts to invoke the decline in the price of White Shield stock occasioned by their fraud to their own advantage are no more persuasive under State law than under Federal law.

D. Litigation Expenses

Additionally, Faulkner's costs of defending this litigation, including the State Court Action, and prosecuting its counterclaims are compensable damages resulting directly from the fraud. *Gantell* v. *Friedmann,* 197 N. Y. S. 2d 605 (Sup. Ct. 1959). In *Gantell,* the defendant alleged that the plaintiffs fraudulently induced the defendant to sign a contract. The plaintiffs brought suit on the contract and the defendant counterclaimed for the legal fees incurred in defending against the fraudulent claim. Rejecting the plaintiffs' motion to dismiss the counterclaim, the Court stated:

> "Defendant's right to maintain this counterclaim does not hinge upon a label. New torts are created every day. 'What is important is that there must be the infliction of intentional harm, resulting in damage, without legal excuses or justification.' Penn-Ohio Steel Corp. v. Allis-Chalmers Mfg. Co., 7 A. D. 2d 441, 184 N. Y. S. 2d 58, 60; Gale v. Ryan, 263 App. Div. 76, 31 N. Y. S. 2d 732; Al Raschid v. News Syndicate Co., 265 N. Y. 1, 191 N. E. 713. Assuming the truth of the facts pleaded, *the counterclaim pleads sufficient facts to charge an intentional harm by the alleged fraud in procuring and uttering the document, which caused defendant to suffer actual damage in his economic and legal relationships. In an action of this nature, defendant's legal expenses could be recovered.* Polo v.

Edelbrau Brewery, Inc., 185 Misc. 775, 60 N. Y. S. 2d 346; Penn-Ohio Steel Corp. v. Allis-Chalmers Mfg. Co., supra." Id. at 608 (emphasis added)

Turning to the present action, Faulkner has alleged that plaintiffs and Tobey & Kirk engaged in an unlawful distribution of the White Shield stock and induced Faulkner to enter into an agreement to purchase part of it, knowing that Faulkner was making a market in the stock, and was thus agreeing to purchase it for resale in the ordinary course of its business. But when the stock was delivered and Faulkner ascertained the actual status of the stock, it rejected the stock, and because it could not cover its resales by open market purchases and held no White Shield stock in inventory (affidavit of Marc R. Green, sworn to May 7, 1973, ¶¶ 11-16; A-454-5), it cancelled the resales, to its loss—a loss which was the direct and foreseeable consequence of the fraud.

Thereafter, plaintiffs had the incredible temerity to commence a lawsuit because Faulkner would not cooperate with plaintiffs in their unlawful plan. Accordingly, by reason of the principles enunciated above, Faulkner is entitled to recover its costs in defending this action and the State Court Action, in proving the fraud and in recovering the loss it sustained by reason thereof.

E. Punitive Damages

Faulkner does not contend it may recover punitive damages on its Federal claims. However, it may assert claims for punitive damages in connection with its pendent claims under State law. *Flaks* v. *Koegel,* 504 F. 2d 702 (2d Cir. 1974); *Young* v. *Taylor,* 466 F. 2d 1329, 1338 (10th Cir. 1972); *Coffee* v. *Permian Corporation,* 474 F. 2d 1040 (5th Cir.), *cert. denied,* 412 U. S. 920 (1973); *Gann* v. *Bernzomatic Corporation,* 262 F. Supp. 301, 304 (S. D. N. Y. 1966); *Hoche Productions, S. A.* v. *Jayark*

Films Corporation, 256 F. Supp. 291 (S. D. N Y. 1966). See also *American Bank & Trust Co.* v. *Barad Shaff Securities Corp., supra.*

Faulkner is entitled to assert claims for punitive damages under New York law. *Walker* v. *Sheldon*, 10 N. Y. 2d 401, 233 N. Y. S. 2d 488 (1961); *Underwriters' Laboratories, Inc.* v. *Smith*, 41 Misc. 2d 756, 246 N. Y. S. 2d 436 (Sup. Ct. 1964).

By Faulkner's counterclaims, it is complaining of precisely the kind of conduct in respect of which punitive damages are appropriate. Faulkner is not complaining of an isolated instance of deceit. It is complaining of a pattern of misrepresentation, concealed by the delivery of false confirmations, in the context of an unlawful distribution of stock attended by various violations of Federal and State law, to the injury of Faulkner and the public purchasers of the stock.

The sales by plaintiffs and Tobey & Kirk to Faulkner and to Singer and the other dealers were deliberately made to them as market-makers, and the purchasers, acting unaware, were holding up the market price of the stock with their own purchases and their own quotations in the "Pink Sheets" and NASDAQ, while distributing the stock to the public at those prices. The plan of plaintiffs and Tobey & Kirk thus constituted a flagrant violation of Rule 10b-6, as well as Section 352-c of the New York General Business Law. But after the distribution was completed, it was the ultimate purchasers of the stock who suffered the losses.

In this context of misrepresentations, market manipulation, the delivery of false confirmations and violations of Federal and State law, resulting in injury to Faulkner and the public purchasers of the stock distributed, it is respectfully submitted that punitive damages are more than justified under New York law.

The District Court held, by the original Decision, that there were disputed issues of fact which precluded sum-

mary judgment on Faulkner's third counterclaim. By the Amended Decision, summary judgment was granted against Faulkner on that counterclaim because of the determination made by the District Court that Faulkner was not entitled to damages, and thus could not assert a claim for affirmative relief.

However, as set forth above, there are several elements of damages which Faulkner may seek to recover. Accordingly, it is submitted that the dismissal of Faulkner's counterclaims was patently erroneous and should be reversed.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the judgment below should be affirmed, insofar as it dismisses plaintiffs' counterclaim and Faulkner's first counterclaim, and reversed, insofar as it dismisses Faulkner's second and third counterclaims; and that summary judgment should be granted to Faulkner on its second, third, fourth, fifth, seventh and ninth affirmative defenses.

Respectfully submitted,

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